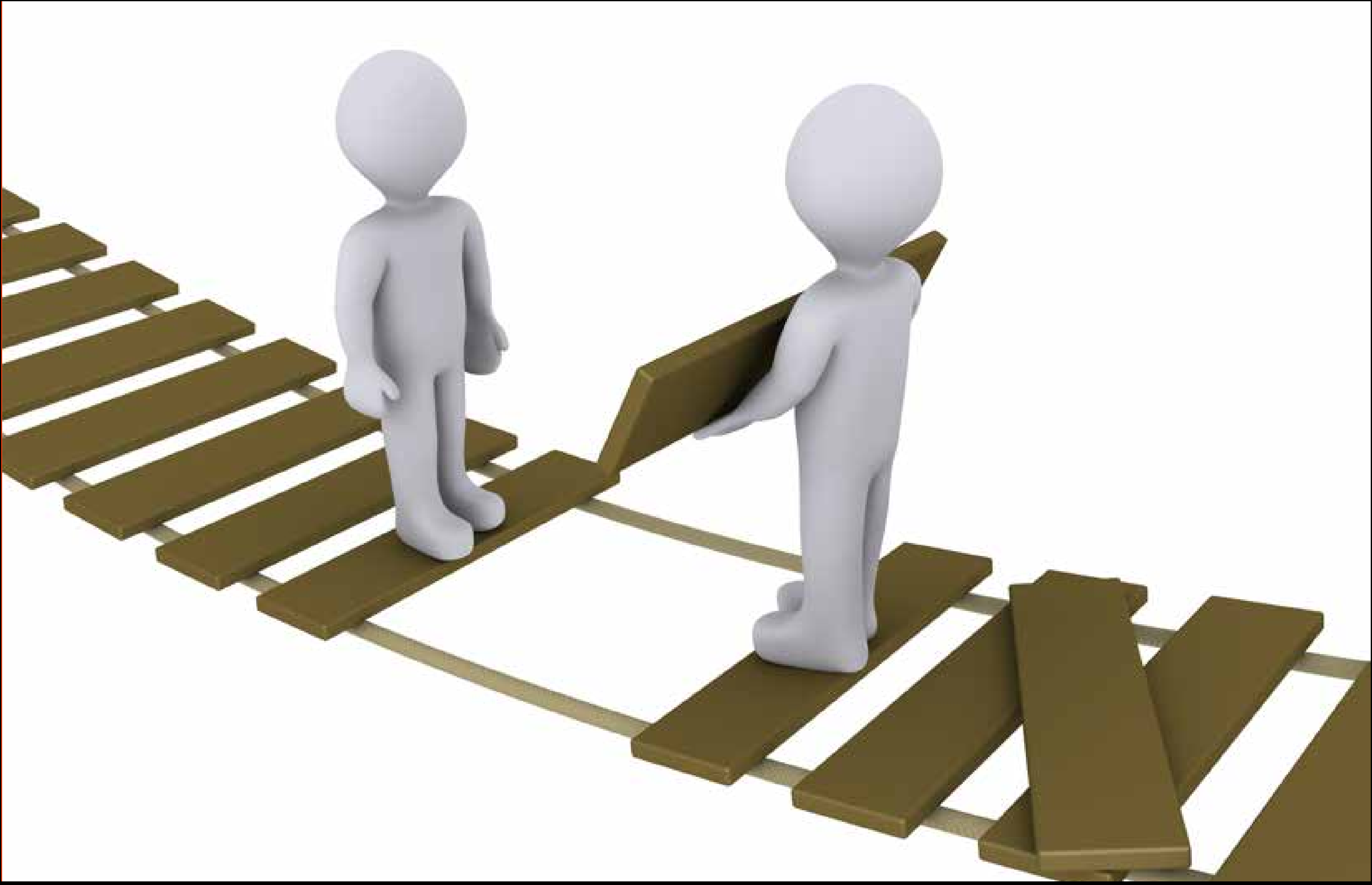

SME Banking

Stage 3

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SME Banking

Stage 3

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Contents

Part One

Part 1: Introduction, Background & Global Scenario

Student Learning Outcomes

By the end of this chapter you should be able to:

- Define SME.
- Define SME from a global perspective.
- List and describe the various classifications of SMEs.
- Identify the popular sectors of SME and describe their characteristics.
- Explain the organizational structure of SME.
- Describe the inherent strengths and weaknesses of SMEs.
- Discuss the need for appropriate governance in the SME arena.
- Explain the important characteristics of an optimal 'ecosystem' for the growth of SME sector.

Small and Medium Enterprise (SME) is a term for segmenting businesses and other organizations that fall somewhere between the "small office-home office" (SOHO) size and the larger enterprise . SMEs are widely defined in terms of their characteristics, which include the size of capital investment, the number of employees, the turnover, the management style, the location, and the market share. Country context plays a major role in determining the nature of these characteristics, especially, the size of investment in capital accumulation and the number of employees. For developing countries, small-scale enterprises would generally mean enterprises with less than 50 workers and medium size enterprises would usually mean those that have 50-99 workers. In most economies, smaller enterprises outnumber large companies by a wide margin.

SMEs in developing countries are often referred to as the

backbone of an economy and are said to be responsible for driving innovation and competition in many economic sectors. They are an essential source of jobs, create entrepreneurial spirit and innovation and are thus crucial for fostering competitiveness and employment. The abundance of labor and the shortages of capital which are characteristics of developing countries are comparable with the SMEs labor intensive character. In more developed economies, the dynamic arguments for the existence of SMEs have been stressed in terms of their being more innovative and constituting a seedbed for the development of new firms.

Authorities in Pakistan do not have a single definition for Small and Medium Enterprises and various Government agencies, e.g. State Bank of Pakistan (SBP), Federal Bureau of Statistics (FBS) and Provincial Labour Departments etc. use their own definitions.

SMEDA (Small and Medium Enterprises Development Authority) defines SME according to the dual criterion of productive assets and number of employees as being an entity which does not employ more than 250 employees with paid up capital up to 25 million and annual sales up to PKR 250 million.

The State Bank defines SME as an entity, ideally not a public limited company, which does not employ more than 250 persons (if it is manufacturing /service concern) and 50 persons (if it is trading concern) and also fulfills the following criteria of either 'a' and 'c' or 'b' and 'c' as relevant:

(a) A trading/service concern with total assets at cost excluding land and building up to Rs 50 million.

(b) A manufacturing concern with total assets at cost excluding land and building up to Rs 100 million.

(c) Any concern (trading, service or manufacturing) with net sale not exceeding Rs 300 million as per latest financial statements.

Following are the SME Definitions used by various institutions in Pakistan:

Institution	Small	Medium
SME Bank	Total Assets of Rs. 20 million	Total Assets of Rs. 100 million
Federal Bureau of Statistics	Less than 10 employees	N/A
Punjab Small Industries Corporation	Fixed investment. up to Rs. 20 million excluding land and building	N/A
Punjab Industries Department	Fixed assets with Rs. 10 million excluding cost of land	
Sindh Industries Department	Entity engaged in handicrafts or manufacturing of consumer or producer goods with fixed capital investment up to Rs.10 million including land & building	

Classification of SMEs:

The major classification used by most countries to define SMEs is according to their number of employees, annual turnover and total assets. However, the size ranges of their classification differ, since developed countries have large industries than the less developed ones. Hence, what might be considered as "small" by developed countries will already fall into the "medium" or "large" category for developing countries. Different countries classify SMEs differently.

United States of America (USA)

The definition of small business is set by a government department called the Small Business Administration (SBA) in U.S. According to the Small Business Act, a small business concern is "one that is independently owned and operated and which is not dominant in its field of operation." The SBA defines SMEs as stand-alone enterprises with fewer than 500 employees.

United Kingdom (U.K.)

Sections 247 and 249 of the Companies Act 1985 classify an SME as one that has a turnover of not more than £5.6 million, a balance sheet total of not more than £2.8 million and not more than 50 employees. A medium-sized company has a turnover of not more than £22.8 million, a balance sheet total of not more than £11.4 million and not more than 250 employees.

European Union (EU)

EU has classified SMEs in three distinct categories; medium-size, small and micro; "The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding 50 million euro, and/or an annual balance sheet total not exceeding 43 million euro".

"Small enterprises are defined as enterprises which employ fewer than 50 persons and whose annual turnover or annual balance sheet total does not exceed 10 million euro".

"Micro enterprises are defined as enterprises which employ fewer than 10 persons and whose annual turnover or annual balance sheet total does not exceed 2 million euro".

Following is a snapshot of SME classifications in selected Asia Pacific Economic Cooperation (APEC) member countries:

Country	Sector	Employment	Other Measures
Australia	Manufacturing	Less than 100 employees	
	Services	Less than 20 employees	
Canada	Manufacturing	Less than 500 employees	
	Services	Less than 50 employees	
China	Varies with Industry	Usually less than 100 Employees	
Indonesia		Less than 100 employees	
Japan*	Manufacturing	Less than 300 employees	¥100 million assets
	Wholesaling	Less than 100 employees	¥30 million assets
	Retailing-Services	Less than 50 employees	¥10 million assets
Korea	Manufacturing	Less than 300 employees	
	Services	Less than 20 employees	
Malaysia	Varies (for SMI)	Less than 75 employees	Less than RM 2.5 million
Philippines		Less than 200 employees	P 40 million assets
Singapore	Manufacturing		less than S$12 million fixed assets
	Services		Less than 100 employees
USA		Less than 500 employees	

COMMON CHARACTERISTICS OF SMEs:

(a) Born out of individual initiatives & skills

SME startups tend to evolve along a single entrepreneur or a small group of entrepreneurs; in many cases; leveraging on a skill set. There are other SMEs being setup purely as a means of earning livelihood.

These includes many trading and retail establishments while most countries confine SMEs to manufacturing services, others adopt a broader definition and include retailing as well.

(b) Greater operational flexibility

The direct involvement of owner(s), coupled with flat hierarchical structures and less number of people ensure that

there is greater operational flexibility. Decision making such as changes in price mix or product mix in response to market conditions is faster.

(c) Low cost of production

SMEs have lower overheads. This translates to lower cost of production, at least up to limited volumes.

(d) High capacity to innovate export

SMEs skill in innovation, improvisation and reverse engineering are legendary. By being able to meet niche requirements, they are also able to capture export markets where volumes are not huge.

(e) High employment orientation:

SMEs are usually the prime drivers of jobs, in some cases creating up to 80% jobs in an economy. SMEs tend to be labor intensive and are able to generate more jobs for every unit of investment, compared to their bigger counterparts.

SME landscape is generally characterized by three broad industry groups:

1. Manufacturing:

The enterprises engaged in the manufacture or production of goods for eg. textile, chemicals, vehicles,beverages, medical and optical instruments, household and other personal goods, etc.

2. Trading (Wholesale & Retail):

The enterprises engaged in the retail and wholesale trading of goods, including their repair and maintenance.

3. Services:

The enterprises engaged in providing or rendering of services and include, though not restricted to, transport, communication, hotels, education, health and social work.

Organizational Structure/Management Level of SMEs

The SME sector is a less formally organized sector in the country and organizational structure in SMEs is organic compared to a more bureaucratic structure in large firms. A salient feature of an organic organization is the absence of standardization and the prevalence of loose and informal working relationships. These characteristics make SMEs more flexible to environmental changes and research has found that small firms are perceived of as being significantly more flexible than large firms. Therefore, SMEs are more likely to survive in turbulent environments than large bureaucratic organizations, where innovation and/or flexibility to adapt to new situations are the key factors. The flat structure of SMEs and lack of hierarchy allows them to have a more flexible work environment and enables the top management to build a strong personal relationship with employees.

SMEs then are characterized by an absence of standardization, formal working relationships and having a flat organizational structure where staff development is limited.

The division of work in SMEs is not clear. When workload is small, employees must take up other kinds of work thus reducing personnel cost. Organizational structure, those of SMEs are more flexible and simple. Owners of SMEs, under the consideration of cost, do not follow the pattern of the organizational division of work as large-scale enterprises do. When there is less business load, an employee can undertake all sorts of different work. As business grows, owner will add more employees to meet the need.

However, on the flip side, it has been recorded in a number of studies that the economic performance of SMEs of Pakistan is negatively affected by the insufficient managerial skills, especially of the small firms. Small firm management comes across several challenges which badly impact firm productivity and performance. The majority of the SMEs struggle to increase productivity, organizational effectiveness, sustained competitive advantage and satisfactory rate of return on investment. It is not an easy task to achieve such kind of objectives in an economy where traditional and informal practices of business management are still applied. The foremost cause of low management skills of SMEs is the low educational and professional training of the business managers.

In particular, SME managers are found deficient in book-keeping, marketing, cost accounting, stock management, production scheduling and quality control. The managers are unaware of the

importance of assets valuation and in some cases even adopt personalized management style, all resulting in low economic efficiencies.

Significance of SMEs

Small and medium enterprises play a catalytic role in development process of most of the economies. SMEs are considered the engine of economic growth in both developed and developing countries, as they:

- Provide low cost employment since the unit cost of persons employed is lower for SMEs than for large-size units.
- Assist in regional and local development since SMEs accelerate rural industrialization bylinking it with the more organized urban sector.
- Help achieve fair and equitable distribution of wealth by regional dispersion of economic activities.
- Contribute significantly to export revenues because of the low-cost labour intensive nature of its products.
- Have a positive effect on the trade balance since SMEs generally use indigenous raw materials.
- Assist in fostering a self-help and entrepreneurial culture by bringing together skills and capital through various lending and skill enhancement schemes.
- Impart the resilience to withstand economic upheavals and maintain a reasonable growth rate since being indigenous is the key to sustainability and self-sufficiency.

Strengths and Weaknesses of SMEs

In order to compete successfully with larger players, many SMEs have developed characteristic competences as:

- Close relationships with customers,
- Continuous innovation,
- A narrow market focus or niche strategies that allow them to specialise and excel in theirfields, and
- Selected and motivated employees.

The special strengths and weaknesses of SMEs that distinguish them from larger companies are mainly determined by their typical characteristics. The most influential ones are **ownership**, **structures** and **size**, which all have positive and negative effects.

Due to their size and number of employees many SMEs have **simple structures and systems**. Mintzberg (1999) describes simple structures as follows: "… it has little or no staff, a loose division of labour and a small managerial hierarchy. Little of its activity is formalised, and it makes minimal use of planning procedures or training routines. … Power tends to focus on the chief executive, who exercises a high formal profile. … The creation of strategy is, of course, the responsibility of the chief executive, the process tending to be highly intuitive."

These simple centralised systems facilitate flexibility and shorter reaction times. They are the basis for SMEs' ability to adapt quickly to changes in their environment. However, these systems are often based on the owner's personal experience and less on objective reasons. Hence, they often remain unchanged, even if circumstances would require other structures and systems. The whole strategic direction is often completely dependent from one individual or a small group of individuals over a long period of time.

SMEs are defined as **independently owned, mostly by families, individuals or small groups of individuals.** Kets de Vries (1993), a clinical professor of leadership development at INSEAD, states the following advantages and disadvantages of family-owned businesses. Those are relevant to other individually owned businesses as well.

Positive Aspects	**Negative Aspects**
▪ Long-term perspective ▪ Dependable culture that encourages long-lasting relationships with all business partners ▪ Strong identification/ commitment,stability ▪ Knowing the business ▪ Family culture as a source of pride, greater resilience in hard times	▪ Static thinking ▪ Managerial difficulties when family objectives and business objectives are in conflict ▪ Less access to capital markets ▪ Nepotism ▪ Succession problems

The issue of nepotism indicates that the overall stable relationships small businesses develop with their partners can turn into a weakness when they favour only relatives and friends. This can make it very difficult for outsiders to come into the business, hence makes it more difficult to attract outside expertise and professional management.

The relatively **small size** of SMEs often leads to disadvantages in economies of scale. This small size leads to one of the SMEs greatest strengths – their ability to offer customized and specialized goods and services. This, however, implies that many SMEs cannot make use of cost advantages in mass production. Furthermore, some types of costs are not variable in relationship with company size. Examples are devices for environmental protection (e.g. gas cleaning equipment), which are often under-utilized in smaller companies, or R&D (Research and development) costs. R&D as the basis for SMEs' strength in innovation and flexibility has to be undertaken on a certain minimum scale in order to lead to results. In the result of lower sales and not down-sizable costs, SMEs often incur a higher proportion of fixed costs compared to larger corporations.

The sum of issues illustrated above leads to a major problem for many SMEs: a lack of resources. This comprises financial and personnel resources.

SMEs have limited access to capital markets, due to owner-preferences and minimum requirements of capital markets. Hence, they are heavily reliant on bank loans and the often limited financial means of their owners. In addition, although smaller companies tend to have a higher turnover yield, larger corporations are in a better position to cover temporary losses. They normally have much higher financial and non-operational incomes and a better equity capitalization. As a result, SMEs tend to have more difficulties to finance investments or R&D projects.

Limitations in personnel resources are relevant to management and functional experts. In both areas, SMEs often lack the financial resources to hire experienced specialists. Often companies are too small to fully utilize a person solely employed for Marketing or IT, etc. Hence, other members of staff have to take over these functions, although they are not necessarily qualified for this. The simple, less fixed structures facilitate such cross-functional working. The result is not only a lack of experience but also a lack of capacity in manpower, especially for one-off projects. A special problem for owner-managed enterprises is to get outside management expertise into the company. Even if the owner is willing to share tasks with outsiders, such functions are often not attractive due to the dominance of the owner. As a result, many companies rely solely on the owner's knowledge and vision, which might be limited to his experience.

Many SMEs are very focused on the owner. The businesses'

success and market position depend on the vision and the entrepreneurial talent of these persons. A well-managed small or medium sized business may be able to overcome size-specified problems of resources by implementing and intelligent outsourcing strategy, by focusing on few core competencies and by developing a motivating corporate culture. Lastly, SME marketing is haphazard and informal because of the way an owner manager does business; they make most decisions on their own, respond to current opportunities and circumstances and so decision-making occurs in a haphazard and apparently chaotic way, according to personal and business priorities at any given point in time. Clearly such limitations will influence, indeed determine, the marketing characteristics of an SME. SMEs do not conform to the conventional marketing characteristics of marketing textbook theories. Thus, SME marketing is likely to be haphazard, informal, loose, unstructured, spontaneous, reactive, built upon and conforming to industry norms.

There is no doubt that SMEs face some special problems that are not an issue for larger organizations. Small size, however, is not necessary equal to disadvantages and problems. Many SMEs are much more flexible than their large counterparts, which have to meet a great variety of expectations and interests from various stakeholders when it comes to changes. Simple structures and few levels of hierarchy encourage a motivating community-like culture and a steady knowledge transfer between all members of the organization. The stable relationships with suppliers and customers that many SMEs have developed over years provide a degree of continuity. Small businesses can form ad hoc partnerships and networks with other businesses in order to work on a particular project.

Moreover, SMEs are famous for their successful niche strategies. Businesses with such a strategy operate in particular market segments. Due to this specialization the business can perfectly serve this market. However, due to the limited market volume, these segments are fairly unattractive for larger players. In the result, the small niche player does not face a significant competition.

Thus its obvious that the special characteristics of small and medium sized enterprises do not only cause problems, but also present a variety of opportunities. The most important precondition for successful exploitation of these opportunities is a qualified management. It is the management's task to make the best out of the strengths in order to overcome the weaknesses.

Need for Appropriate governance in the SME arena

Small and medium-sized enterprises (SMEs) are important agents of development throughout the world. Promoting a country's SME sector plays a crucial role in maintaining high employment and income generation and is therefore critical for achieving sustainable growth.

While it is generally accepted that SMEs are important contributors to the domestic economy, not many governments have framed policies to enhance their contribution or increase their competitiveness. Most governments do not even have reliable statistics on SMEs. The statistics on SMEs are poor for a number of well-known reasons: lack of a uniform definition, high cost of an industrial census, and the fact that many SMEs do not register and remain outside the formal economy.

In order to get governments to focus on both macro and micro policies, particularly for SMEs, the case must be made for supporting SMEs. The case for government intervention to assist SMEs is based on the fact that numerous market failures prevent domestic enterprises from building capabilities because they cannot access finance, information, technology and markets in addition to cumbersome bureaucratic procedures in setting up, operating, and sustaining a business; poor infrastructure; and the lack of effective institutional structures.

Specific policies, programs and appropriate institutional frameworks are needed to help SMEs overcome these failures. To transit the high road to competitiveness, firms both large and small in developing countries have to build and continuously enhance endogenous capabilities. These capabilities can be applied to add value to existing activities and to make new products and start new services that can compete in the global economy. Although a number of enterprise policy instruments have been used in some developing countries, there is plenty of room for identifying and applying measures for the financing of SMEs, including through venture capital; for linkages between foreign and local enterprises; and for the promotion of R&D, technology diffusion, adaptation and mastery.However, most developing countries have neither technology nor enterprise polices and the challenge for them is to adopt them in the near future. To avoid possible coordination failures it is important to create institutions to articulate and lead the multiple efforts to be made at the macro-, meso-, and micro-levels. This however, is not possible without government intervention in the SME sector to facilitate and promote SME business.

Conditions for the Maximization of the SME Sector Contribution

The ultimately interesting question for economists is "Under what conditions (including those affected by policy) can SMEs make their biggest potential contribution to a healthy economy?" One ideal condition is well-functioning markets. SMEs are often disadvantaged vis a vis large firms by market imperfections, especially in the capital and product goods markets. In contrast, labour market imperfections, including labour legislation, tend to favour them. Public policies in other areas more often favour large firms. Since most market imperfections cannot be fully, often not even partially, removed, policy analysis must be carried out in the context of the "economics of the second best." It is interesting to consider the role of tax policy in this light.

A background observation is that the microenterprise (or informal) sector is usually thought of and sometimes even defined as the sector to which rules and regulations do not apply. This is a matter of degree, but it does capture the important point than many policies are not likely to have much, if any, direct impact on this sector. At the other extreme, large firms have to respond to virtually all laws and regulations, even if they are able to avoid those regulations in part. The SME sector, intermediate in so many other respects, is also intermediate in that many regulations and aspects of public policy, including many taxes and much labour legalisation are partially applied here. Should they be fully applied or not? Should policy and regulations be designed differently for this sector than for others? One vantage point to ask the question "what should policy—including tax policy, towards the SME sector be?" is to identify and to the extent possible quantify the effects of the market imperfections impinging on the sector's capacity to fulfill its potential role.

On the one hand, the tax burden and labour costs typically rise by firm size; on the other access to low cost capital and ability to exercise market power also rise. Other considerations in thinking about overall SME policy are the matter of whether (as is usually assumed) it tends to be smaller than would be desirable from a social point of view and by how much, and with respect to which other sector (large firms/government or micro enterprise) it is mainly in competition with. Unlike large firms, but somewhat parallel to micro enterprise, SMEs are not normally in a position to undertake their own R&D or much of their own human capital formation. This creates logic, parallel to that for small agriculture (or rather for agriculture in general) that the state be heavily involved in the R&D function.

These issues affect the optimal design of tax policy in several

ways. First, seen as one of several factors that may create biases for or against SME activity, one should in principle strive for a tax burden relative to large firms that tends to keep the overall incentive for the two sectors fairly close (i.e. creates a "level playing field"), though somewhat stronger for SMEs because of their advantage on the employment and distributional fronts.

Second, one should keep in mind the technology choice impacts of the structure of taxes. It is arguable, though seldom studied in enough detail to confirm the hypothesis, that it is within the SME sector that things like tax policy and labour legislation are most likely to have an impact on technology choice and hence on decent employment creation. In general, the large firm sector is likely to employ quite capital intensive technologies in most countries regardless of legislation in either of these areas, even though they may have some impact in some industries and in some countries. At the micro enterprise level, they have little or no impact. But the SME sector is the one which does create many decent jobs and where technology choice is likely to be more sensitive to the incentives created by the details of legislation in these two areas.

Part Two

SME Sector in Perspective

Student Learning Outcomes

By the end of this chapter you should be able to:

- **Discuss the global outlook on SME sector and explain its importance in the international market.**
- **Explain the popular practices adopted by SMEs for surviving through economic cycles.**
- **Describe the growth opportunities that exist for SMEs globally.**
- **Differentiate between lending business models adopted by SMEs in developed and emerging markets.**
- **Discuss the SME banking business models in developed markets.**
- **Discuss the SME banking business models in emerging markets.**
- **Analyze the trends that exist in financing the SMEs**

SMEs in the global perspective

A dynamic and competitive SME sector is pivotal for economic renewal and employment. SMEs are generally considered the best "training ground" for entrepreneurship and management skills, have the flexibility to respond quickly to changing demands, and are able to implement new ideas and form new partnerships more easily than larger companies. Given the right framework conditions, SMEs can serve as incubators for new ideas, exercising their ability to act quickly and flexibly, taking advantage of the full range of national resources (irrespective of geographical location), and engaging in experimentation more easily than big, established firms.

SMEs are important to almost all economies in the world, but especially to those in developing countries and, within that broad category, especially to those with major employment and income distribution challenges. On what we may call the "static" front,

SMEs contribute to output and to the creation of jobs; on the dynamic front they are a nursery for the larger firms of the future, are the next (and important) step up for expanding micro enterprises, they contribute directly and often significantly to aggregate savings and investment and they are involved in the development of appropriate technology. In asking ourselves how "important" the SME sector is we must of course go beyond simply looking at its share of output, employment or any other aggregate variable to the key question-- "how much difference does it make to overall economic performance whether the SME sector is large or small, or whether it grows rapidly or slowly?"

In the Asian and Pacific countries, SMEs have been contributing significantly towards the creation of a healthy, entrepreneurial climate and the generation of employment, thereby commanding a sizeable share in the region's economy. For instance, SMEs constitute 99.8% of the total number of enterprises in the Republic of Korea. This is true also of other countries in the region: 99.7% in Singapore and Thailand; 99.6% in the Philippines; 99.0% in China; 98.9% in Japan; 98.0% in Hong Kong; and 97.7% in Taiwan. Malaysia has a comparatively lower figure: 92.0% of the total 689,160 registered enterprises. According to Economic Survey 2008, there are about 3.2 million enterprises in Pakistan, of which about 3 million (93%) are SMEs. SMEs spread across the economy with verging density: highest in wholesale and retail trade and resturants and hotel (53%), followed by other services (27%) and the manufacturing sector (20%). The SMEs census shows that SMEs contribute over 30% to the GDP and 25% to the countrys total export earning, and they employ 70% of the labor force in the manufacturing industry, service and trade

In terms of employment, the SME employees account for a sizeable percentage of the total employed population: Republic of Korea, 86.7%; the Philippines, 70.0%; Japan, 69.2%; Taiwan, 68.8%; Hong Kong and Thailand, 60.0%; and Singapore, 57.0%. In the manufacturing sector in Malaysia, SMEs account for 30.7% of the total employment. Research has established that a country's emergence and growth is influenced by critical factors such as learning and the capabilities of domestic firms; result-oriented government policies; a highly skilled labour force; flourishing entrepreneurship; some key large firms; and the dominant driver of growth – the highly dynamic SMEs.

An important challenge in many countries is to assure that a significant share of output takes place outside the overly capital intensive large scale sector. Achievement of this goal is more

difficult if SME activity in general is discouraged by policy or setting. It can be facilitated when large firms (whose size may be necessary because some parts of the process leading to their final goods have economies of scale) subcontract other parts of that process to smaller more labour intensive firms. It can also be facilitated by the phenomenon referred to as "clusters" in which small firms collaborate together to handle those aspects of the business that are indeed characterized by economies of scale. The ideal setting within which SMEs can play their positive contribution to the maximum thus includes these structures and their advantages.

In developing countries with large informal or micro enterprise sectors, SMEs constitute the middle of the size range, a fact that explains much of their strategic importance. In terms of organizational structure, SMEs are, on average, considerably more complicated than microenterprise, which involve largely the self-employed, sometimes accompanied on the job by a few family workers and hence usually having under 5 workers. On the other hand, SMEs are, on average, a good deal less complicated structurally than are corporations and other large firms, with their layers of management, high division of labour, etc.

In addition to generating employment, SMEs play an imperative role in strengthening economic performance, something which has been important particularly during the general economic slowdown. In transition economies, SME have already replaced numerous jobs lost during periods of reconstruction and downsizing of former large state-owned enterprises. In addition, by nature SMEs contribute to the democratization and decentralization processes in transition economies. They increase flexibility when providing goods and services, help to increase the competitiveness in national economies and spread risk in the general business environment.

As with any other component of an economy, the size and importance of the SME sector varies from country to country; the last few decades have seen an increasing recognition of the role it plays in industrial countries, something already more obvious for developing nations from the 1970s onwards.

Survival of SMEs

SMEs are often the main driver for a country's economic growth. However, as the number of SMEs increases, competition increases, which then results in a decrease in prices, customer base, or both. This in turn will erode existing profits, creating less incentive for people to start SMEs. This dynamic is captured by

balancing feedback loops where the greater the number of SMEs, the greater the competition, resulting in a slower rate of growth for SMEs. Foreign firms in both the import and export markets further add to competitive pressures, especially if they react faster to improve their product, process, promotion, or distribution channels.

To counter the increasing competition and to survive, SMEs lower their prices, increase promotion of their product, improve their product, add new distribution channels, and/or improve their internal processes. The challenge is to counter competition when the firm still has the financial resources to do so. Otherwise, once the pressure of competition sufficiently erodes the SME's profits, it will no longer have resources to counter the competition and will have to exit the market.

SMEs start focusing on developing their products unique selling proposition based on the initial reaction from the customers. During this phase, there is a shift in emphasis away from establishing the firm in the market towards identifying new customers, that is, a greater shift towards the marketing function. Also, the firm has built up credibility in the marketplace and has established the technical capabilities of its product offering. The need to improve internal reporting and to improve financial control systems becomes a priority and this is largely due to the economies of scale taking effect since the firm's product lines become more standardized and attract a wider array of customers.

Since the product offering attracts a wider array of customers, new distribution channels are developed. Product and market research is still a low priority within the firm. As the customer base begins to expand, the SME owner begins to consider systems and controls. While up to this point, they could monitor all aspects of the business personally; continued growth has made this increasingly difficult necessitating the introduction of basic systems and controls. While the direct hands-on style of management of the owner-manager was important in getting the business established, in essence, it creates a situation where the employees find themselves restricted by the owner's attempts to monitor everything and, as they understand their role in the organization, they need autonomy and freedom from the owner's watchful eye. Therefore, so as to avoid disenchantment and in order to motivate their employees, the owner must delegate authority and give their employees more responsibility. This enables them to be more responsive and allows them to take initiative without having to have everything checked by the owner.

In order to counter competition and survive, SMEs also take advantage of the stream of innovations in information technology (internet and electronic commerce) to reach new customers and to increase interaction with old ones. Lastly, making use of modern business methods, efficient equipment and procedures also ensure that small businesses remain competitive and efficient relative to its competitors.

Growth opportunities for SMEs globally

The rapidly increasing role of emerging economies in international trade, value creation and global growth present new opportunities for SMEs in global markets. Globalization and regional integration processes are increasing in terms of speed and space. Countries that are able to take advantage of these two underlying fundamental forces have been growing faster and more sustainably. At the same time, economic openness and domestic trade and investment liberalization have dramatically increased competition in the domestic, regional, and global marketplace. Larger and efficient companies are normally able to leverage these new opportunities and challenges in domestic markets as well as across external markets. This challenging new economic environment tends to put SMEs at a disadvantage compared to large and medium-sized enterprises. However, there is empirical evidence to indicate that in spite of this, SMEs continue to develop and prosper in some countries. For example, SMEs in Japan, Korea, Taipei, China, Hong Kong, China, and Singapore are doing well and expanding. SME growth is not restricted to these countries but also increasingly in Thailand (automobile and electronic), Malaysia (electronic), Philippines (electronic, ICT), India (ICT, services), Australia, and New Zealand (ICT, services).

The fact is that large enterprises (LEs) and SMEs are the two important drivers of development in the developing Asia and Pacific region. While MNCs and domestic LEs have been playing an important role in accelerating the industrialization process, without SMEs as subcontractors and suppliers of intermediate inputs to these MNCs and domestic LEs, industrial growth in developing countries would not be able to realize sustainable increase in domestic value-added, employment, productivity and industrial linkages. In the globalizing era of the borderless marketplace, SMEs provide an important source of domestic employment creation and resilience against more volatile external economic fluctuations, and serve as a mechanism for local capacity building.

SMEs play a pivotal role in the functioning of international and regional production networks. There are certainly ways to foster

local firms and SMEs by utilizing globalizing market forces and regional economic integration; the issue is how to provide a critical linkage between SMEs and the large local companies and MNCs. Successful cases in Singapore and other countries have proven that governments play a vital role in ensuring a competitive market structure, providing relevant and effective technical upgrading, marketing information and management, consortium financing, and clustering (economies of scale) to SMEs.
The development of SMEs in the region is important as success in this effort will go a long way toward reducing regional and domestic income gaps, creating a balance of income and employment, and securing sustainable human and social security. To achieve this, there is a need to improve SMEs' international competitiveness through SME promotion policies, financing, and the tax system. SMEs can be sharpened in their ability to compete through improvement of competitiveness due to research and development, improvement of quality control and skill.

As regional production networking becomes more important as a source of economic growth, outsourcing and subcontracting will offer increasing opportunities for SMEs to capitalize on regional economic integration. Alternative and important emerging business opportunities for SMEs are the advent of Internet businesses and the widespread use of electronic and computer business design. Because of the electronic and computer revolution in business management and practices, many SMEs in Singapore, Hong Kong and China are expanding their business operation from homes and other flexible arrangements. Such flexibility in doing business comes about due to the infinite business opportunities offered through the borderless cyberspace world. This new mode of doing business reduces business and transaction costs enormously.

SMEs are also expanding very rapidly in the service sector of tourism and specialized marketing to newly emerging markets beyond the domestic market as part of regional economic integration. Without a corresponding increase in the efficiency of local firms and SMEs, regional integration cannot be sustained, as there will be more domestic opposition due to increased economic and social instability and unemployment. In addition, regional integration may tend to increase income disparity among members of the preferential trading area, if some countervailing measures are not properly instituted. In this respect, the development of viable and sustainable SMEs provides an effective measure to counter the negative effects of globalization and regional economic integration. Therefore, improving the competitiveness

and capability of SMEs is vital for the sustainability of regional economic integration.

There are manifold elements required to improve the competitiveness of SMEs. Countries at different stages of economic development require different core policy instruments aimed at improving their SMEs' capability development. Experience drawn from successful SME development in Korea, Taipei, China, and Singapore indicates that technology and industry upgrading are the core measures that must be continually implemented in order to stay competitive, in addition to clustering and improved marketing capability.

The importance of SMEs in the age of globalization, production networking, and regional economic integration is well documented and firmly established in the literature. The central question is why some countries have successfully transformed and established viable, competitive, and sustainable SMEs development while the majority of other developing countries have failed. The answer is complex and requiring of country-specific, sectoral level analysis as well as the examination of economic, political, social, and cultural elements in a dynamic context. However, some elements can be used as basic policy guidelines for developing SMEs. Successful cases of SMEs development in Japan, Korea, Taipei, China, Hong Kong, China, Singapore, Thailand, Malaysia, India, and many other countries have adopted long-term comprehensive, coordinated and consistent policies. Often, empirical evidence shows that correct policy measures for SMEs in developing countries are not coordinated among relevant ministries, agencies, and organizations, which in the long run results in inconsistent policies. Therefore, governments and responsible agencies must develop "best practices" on the ideal business environment, training and upgrading, financing, marketing and management, sub-contracting, and networking and monitoring mechanisms to ensure that SME policies are efficiently and effectively carried out.

Banks' business models in serving SMEs in the developed and emerging markets

The financing of small and medium enterprises (SMEs) has attracted much attention in recent years and has become an important topic for economists and policymakers working on financial and economic development. This interest is driven in part by the fact that SMEs account for the majority of firms in an economy and represent a significant share of employment. Furthermore, most large companies usually start as small enterprises, so the ability of SMEs to develop and invest becomes crucial to any economy wishing to prosper.

Below is an analysis from the World Bank survey about the business models banks follow to serve SMEs. In particular, the following questions are addressed: how do banks structure their operations to serve SMEs in developed and emerging markets? What degree of decentralizationdo they allow for? How do banks make lending decisions? What criteria do banks use to make loans? What types of collateral are most commonly used?

Dedicated SME Units

When it comes to the organizational setup banks use to serve SMEs, it is striking that almost all of the banks interviewed in the World Bank survey (77% in Argentina, 88% in Chile, 100% in Colombia, and 88% in Serbia) mentioned that they have separate, dedicated units to manage their relations with SMEs. Most importantly, the units concerned with SMEs are different from consumer and corporate units, and in most cases also separate from the microenterprise business, which banks tend to house either in a unit of its own or as part of the consumer lending unit. This is also a common feature among banks that are leaders in the SME business, according to the IFC interviews in developed and developing countries.

Banks in developed countries are more likely to distinguish between small and medium-sized firms. Relative to private and foreign-owned banks, government banks are somewhat less likely to have separate SME departments. According to this World Bank survey, while 93% of private and foreign owned banks have separate departments for SMEs, approximately 80% of public banks do so.

The majority of banks operating both in developed and developing countries have decentralized the selling of non-lending products to small and medium-sized enterprises. 61% of banks in developing countries and 70% of banks operating in developed countries respond that the sales of non-lending products to small businesses is done only or primarily at branches. Relative to foreign and government-owned banks, private domestic banks are somewhat less likely to decentralize the sale of non-lending products. In contrast to sales, banks' loan approval, risk management, and non-performing loan recovery functions tend to be more centralized, in particular, among developing country banks.

Targeting SMEs

Banks use both branches and headquarters to reach out to SMEs. Headquarters typically design the strategy and the campaign in terms of which SMEs banks will target and what products they will offer them. The products tend to be standardized or combined with some tailored products, with the importance of tailoring rising with

the size of the firm. Banks design products tailored to a group of SMEs with similar needs. For example, banks design special products for schools, fishing companies, and agricultural producers, taking into account their particular business needs, such as paying teachers, buying insurance, or getting credit to purchase inputs during the production cycle. Although the products differ across sectors, the individual SME perceives them as tailored to its specific needs.

Under this model for engaging SMEs, headquarters have an advantage in designing the strategy of which group or sub-sector of SMEs to target. Headquarters are better equipped at taking advantage of synergies arising with "supply chains" and outsourcing arrangements given the close connection with large corporations, which help them sort out which SMEs are worth approaching. Moreover, headquarters can design the array of products to be offered to SMEs to exploit the cross-selling potential. These products could be advertised through centrally designed campaigns to reach out to a large spectrum of SMEs. Headquarters can also use existing databases like business registries to perform data mining and screen SMEs. Furthermore, in the case of international banks, national headquarter offices can obtain information and guidance from the global headquarter offices, who have acquired greater experience in dealing with SMEs worldwide. In this context, branches need to work with headquarters to generate new SME clients, as the relationship manager is not the only person central to the relation with SMEs and his effectiveness is boosted by information and support from headquarters.

Moreover, branches do not operate as separate banks (or niche banks) within the bank. Again, in this context, universal banks have an advantage in exploiting economies of scale compared to small, specialized banks. As they learn to deal with SMEs, banks are reorganizing their credit risk management systems, with a greater degree of sophistication among international banks and the leading, large domestic banks. In most large banks, and with the exception of pure credit scoring, credit risk management is not automated. In most cases, it involves a credit risk analyst. Typically, risk management is a function that is organizationally separate from sales and is done primarily at headquarters.

The risk management department is given independence and strong approval and veto powers, an arrangement not typically found among small, niche, and public banks. While maintaining

independence in judgment, risk analysts and managers work cooperatively with those who sell products and originate loans (e.g., the SME account managers in countries where business models are more advanced). In effect, risk analysts endeavor to train SME account managers and raise their risk awareness, so that the credit approval process is streamlined and the loan application has a higher likelihood of not being rejected later on by risk analysts.

Product offerings

The World Bank survey also indicates that dedicated business units approach SMEs in an integrated way, offering them a wide array of products and services which can typically be divided into 14 categories: checking or savings accounts, investment products, term loans, credit cards, factoring, leasing, international trade financing, foreign exchange, international payments and collection, employee payments, supplier payments, tax payments, collection of receivables, and insurance products.

The diversity and number of products offered is associated with the revenues that these products generate. A study of the revenue breakdown by type of product collected by the IFC in developed and developing countries shows that credit generates only part of the revenue, 32% and 38% for developed and developing countries, respectively. The rest is divided between deposits and other products and services. In the case of developing countries, 29% corresponds to deposits and 32% to other products.

Scoring Models

Large banks use well-developed screening tools to sort out "good" debtors from the loan applicant pool. Banks differentiate these screening tools by firm or loan size. They typically determine the size threshold for the applicability of a given screening tool by the effectiveness of the tool itself, as gauged by repeated experience. Thus, banks usually apply automatic scoring methods to small companies with small loans, for which the owner and SME information is combined. Moreover, banks use back testing or statistical analyses of the effectiveness of automated scoring to determine the threshold size beyond which it is deemed to lose potency.

Banks continuously make efforts to improve the scoring technique to apply it to incrementally larger loans or firms. They use

streamlined and substantially standardized rating tools to screen larger SMEs applying for larger loans, for which banks deem automatic scoring not to be effective. Such tools incorporate quantitative and qualitative information and banks typically develop them by adapting (simplifying, streamlining, and standardizing) to the SME business, the rating methods applied to large corporations. SME ratings do not lead to the automatic approval of loans, but they rather provide the basis for the risk analyst to evaluate loans and decide on their approval. After loans are approved, banks continuously monitor the loans and the SMEs (particularly the larger ones), on top of having an early warning system with triggers to anticipate and detect potential problems.

Some of the larger and more sophisticated banks are embarked in medium-term plans to link screening tools (automated scoring and ratings) to the banks' provision policies (for expected losses) and capital policies (for unexpected losses). They are also developing or perfecting systems and procedures to generate risk-adjusted pricing unit cost accounting per product or service line. Other plans include greater use of stress testing, quantitative analysis, and improved estimates of loss given default and post-default recovery costs. However, despite these plans, in the short-term, banks cope with the difficulties in lending to SMEs by hedging risk, using instruments like short-term loans, offering document discounting, and demanding collateral.

Banks from developed and developing countries are more prone to using scoring models in making decisions regarding small rather than medium-sized enterprise loans. Only 18% of developed country banks, as per the World Bank survey, say they do not use scoring for small business lending, while almost 45% report not using scoring for medium-sized enterprise lending. Among banks in developing countries, a higher percentage is not using scoring, not surprisingly given that they tend to operate in less sophisticated markets with less information available. Comparing banks by ownership type, foreign-owned banks are somewhat more likely to rely completely on scoring for credit decisions than domestic banks, for both small and medium-sized enterprises.This might reflect that foreign banks have better statistical models and/or have less direct contact with borrowers and, hence, have to rely more on arms-length lending techniques. But scoring is used primarily as one input in the lending decision process.

Among banks in developed countries, 82 % say that scoring is only an input into loan decisions for small businesses and 55 % give the same response in connection to loans to medium-sized

enterprises. Foreign banks are most likely to either rely completely or not use scoring at all in lending to small and medium-sized enterprises.

The business models to serve SMEs described above can be better pursued by large universal banks, especially foreign ones, which can be more aggressive in reaching out to SME clients. These banks can better capture economies of scale and economies of scope (within and across countries) and move beyond reliance on relationship lending (which is better conducted by niche banks). Because of their substantial branch network, large universal banks are better positioned to develop low-cost approaches to give SMEs a closer, ‘‘personalized’’ service (or the appearance of it), without moving into costly, full-fledge relationship lending. Business centers capture decreasing costs in certain activities (including risk management and back-office functions), combined with SME account managers to ‘‘personalize’’ the service. Also, large and foreign banks have more large corporate clients and are well-positioned to get information about the valuable SMEs with which the large corporations work, through supply or outsourcing connections. This helps these banks overcome the asymmetric information problems that relationship lending tries to solve.

In terms of risk management, large, universal banks are better suited to conduct lending based on automated scoring models for small loans (since they have the know-how and models to do so). Also, they generally have more advanced risk management systems. Due to their size and to their presence in many different markets, large and foreign banks are better able to diversify away the idiosyncratic risks of SME lending. Also, they are more likely to have advanced methods to assess the value of collateral, better recovery units, and more efficient ways to execute collateral.

Supplier Financing

While there is no replacement for direct small business relationship lending on the part of regional banks, a concurrent approach to SME financing is being undertaken by global banks in partnership with their large clients. Supplier financing has emerged from the global crisis as the poster-child of trade finance for its impact on the cash conversation cycle and bottom line of global corporations; it carries the potential to be leveraged as a similarly powerful tool in collaborative efforts to jump-start SME access to financing.

Under the supplier finance structure, banks purchase the accounts

receivables of SMEs whose buyer is a corporate client. The bank provides immediate cash to the SMEs based on the value of the SME's accounts receivable less a small discount. Upon due date, the bank then collects the full face amount of the accounts receivable from their buyer client.

The SMEs receive several benefits from this type of program in addition to the immediate cash infusion. First, programs that use an electronic interface are able to notify the SME as soon as an invoice has been accepted, approved, and scheduled for payment. This visibility enhances an SME's planning capability and provides early notification in the event that there is a trade dispute. Secondly, when an SME discounts its accounts receivables, the receivables are removed from the balance sheet and create space for direct financing from the SME's normal banking relationship.

A number of global banks have dedicated substantial resources to developing their supplier financing capabilities. This includes the creation of technology platforms that automate the discounting process and enable scaling-up, formation of on-boarding teams that are trained in working directly with SME suppliers to explain the program and help them determine if it supports their business and financing objectives, and due diligence related to cross-border payments and taxation. Policy makers and development professionals are also recognizing the tremendous opportunity to reach SMEs through the global supply chain and to achieve scale in a shorter period of time. National export credit agencies are exploring opportunities in cooperation with banks to provide guarantees on the accounts receivables of suppliers whose buyers are exporting firms. The attractiveness of this approach is that it promotes the cooperation of all stakeholders and has the potential to reach a large number of SMEs in a smaller amount of time. In addition, public sector companies that procure goods and services from SMEs can also play an important partnership role in addressing the challenges that SMEs face.

Criteria for evaluating loans

In terms of the specific factors that banks consider in evaluating loans, we examine separately the criteria used for small and medium-sized business lending and compare this to banks' responses regarding lending to large firms.

The financial assessment of the business is the most important consideration across all firms, although it is more important for large (64%) than for small enterprise lending (49%).

A firm's credit history with the bank is the second most important criterion, with the owner's characteristics and the purpose of the loan being next in importance.

Examining more closely the factors relevant for small business lending, we observe some differences between banks in developing and developed countries. While the size of the loan is the second-most important criterion for developed country banks (20%), the firm's credit history with the bank is the second most important factor in developing countries (16%).There are also some differences across bank ownership types. Most notably, foreign-owned banks tend to base their decisions more on the financial assessment of the business than domestic-owned banks. Specifically, 58% of foreign-owned banks see the financial assessment as the most important criterion compared to 37% of privately-owned domestic banks. This is consistent with privately-owned banks being better able to screen customers using soft information and foreign-owned banks relying mostly on hard, quantifiable information.

Collateral

At least three-quarters of banks require collateral to make business loans. Furthermore, there are no significant differences for small, medium-sized, and large firm financing. As expected, however, given that the informational and institutional environment is weaker in developing countries, a slightly higher percentage of banks require collateral to make business loans in these countries relative to banks in developed countries. Comparing across bank ownership types, we observe that government banks are somewhat more prone to require collateral from medium-sized and large firms relative to the other bank types. While 100% of government banks state that they require collateral for medium and large firm financing, close to 90% of private domestic and foreign-owned banks respond in a similar fashion.

Real estate is the most frequently accepted type of collateral for business lending, regardless of firm size. Close to 40% of banks rank real estate as the most important type of collateral used for small, medium, and large firm financing. Cash and other liquid assets are the second most important forms of collateral used across all firm sizes (approximately 22% of banks rate this form of collateral as the most important), followed by bank and personal guarantees (10-15% of banks).Comparing banks in developed and developing countries, we find that real estate is more frequently

ranked as the most important collateral type by banks in developed countries relative to those in developing countries. Almost 56% of banks in developed countries indicate that real estate is the most important type of collateral for small business lending, compared to 37% of banks in developing countries. There is more variety in the type of collateral that banks in developing countries consider important. While banks in developed and developing countries rank cash, liquid assets, bank and personal guarantees as important collateral types, only banks in developing countries (although a percentage less than 15%) seem to rank land and equipment as important types of collateral.

There are some notable differences in terms of the assets used as collateral across bank ownership types. While for foreign banks, real estate is the dominating asset used as collateral (54% of banks rank real estate at the top), for privately-owned domestic banks, cash and other liquid assets are the most important asset (33%). Government-owned banks seem to be relatively evenly split as to how they rank the importance of different collateral types. Approximately one quarter of government-owned banks rank real estate, land, and equipment as important, respectively. On the other hand, only a small percentage of foreign or private domestic banks rank land and equipment as important.

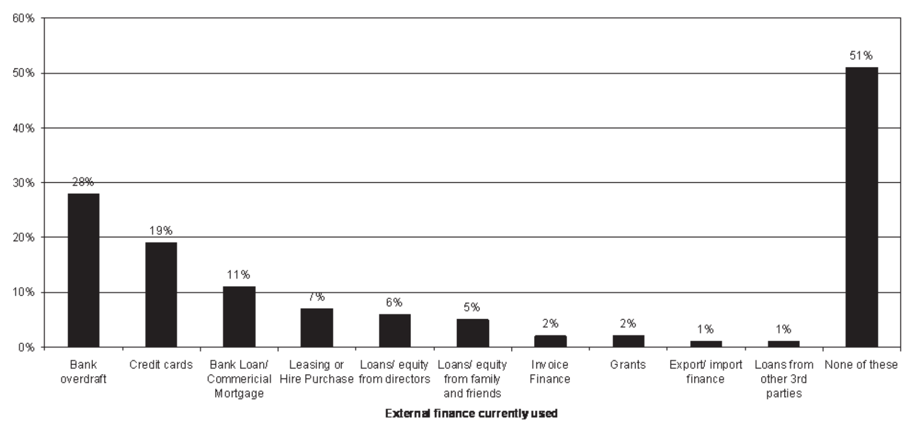
Summarizing, banks across all countries have set up separate departments to serve SMEs, have decentralized the sale of financial products to the branches, but continue to centralize the loan approval, risk management, and loan recovery functions. Though scoring models are used by most banks in the sample, especially in small business lending, they are only one input in the loan decision process. Relative to other banks, foreign banks are more likely to engage in arms length financing, since they are more prone to use scoring, to rely on quantitative information when making loan decisions, and to prefer real estate as collateral. Finally, we also observe some differences in the lending criteria and collateral used by banks operating developed vis-à-vis developing countries. In particular, banks in developing countries are relatively more likely to make lending decisions based on a firm's credit history with the bank and the firm owner's characteristics – a sign that banks in developing countries might be more likely to engage in relationship lending. Furthermore, while real estate is the most important collateral for SME loans around the world, it is less so in developing countries where liquid assets are also commonly used as collateral.

Recent Trends in Finance for SMEs

The following is an excerpt from the Economic Paper by the Department of Business Innovation and Skills dated January 2012 on the recent trends in financing SMEs.

SMEs seek and use a variety of different finance types. Whilst access to finance is important, around half of SMEs do not use formal sources of external finance, instead relying on trade credit from their suppliers or retained earnings. Half of SMEs who use at least one form of external finance most commonly use bank funding; either loans, credit cards or overdrafts. A minority use equity finance, from either venture capitalists or business angels. SMEs do not generally access capital or bond markets due to their size and the small amounts of money they are seeking. Some smaller businesses and start-ups also use personal finance to fund investment and growth or seek finance from informal sources like friends and family.

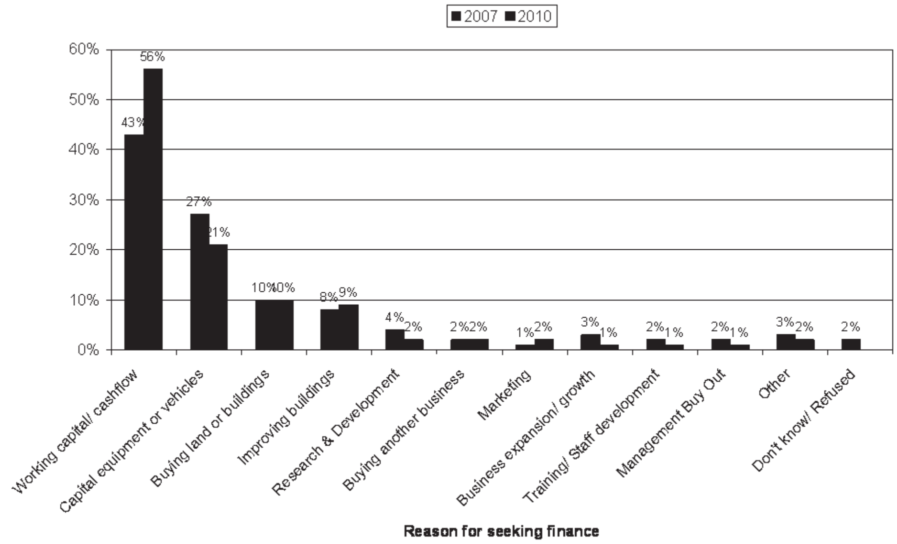
SMEs use of external finance



Source: BIS Small Business Survey 2010

As the recession developed, a greater proportion of SME businesses were seeking finance for cash flow, with a lower percentage seeking finance for investment.

SME Employers reason for seeking finance (2007-2010 Comparison)



Source: BIS Small Business Survey 2010

Of those seeking finance most SME employers seek debt finance (40% seek loans and 35% seek overdrafts) similar to those currently using finance. Only around 1-2% of those seeking finance seek equity finance. Whilst many SMEs use a credit card, a lower proportion actually seek a new credit card, as credit card use is on-going from one year to another.

There has been a decline in bank lending to SMEs

Following a period of sustained growth, the stock of bank lending to SMEs peaked in 2009 and has declined in the subsequent years. Corporate lending peaked in 2008, but declined more sharply than SME lending in 2009 due to the credit crunch. Going into the recession, there is no evidence of the SME sector being over-leveraged, as SMEs were net depositors of funds. The decline in the stock of lending is affected by both supply side factors e.g. bank's reduced appetite for risk as well as demand side factors, with evidence indicating that SMEs are themselves deleveraging by repaying existing bank debt, and more generally putting off investment plans in light of strong economic uncertainty.

The decline is caused by reduction in demand...

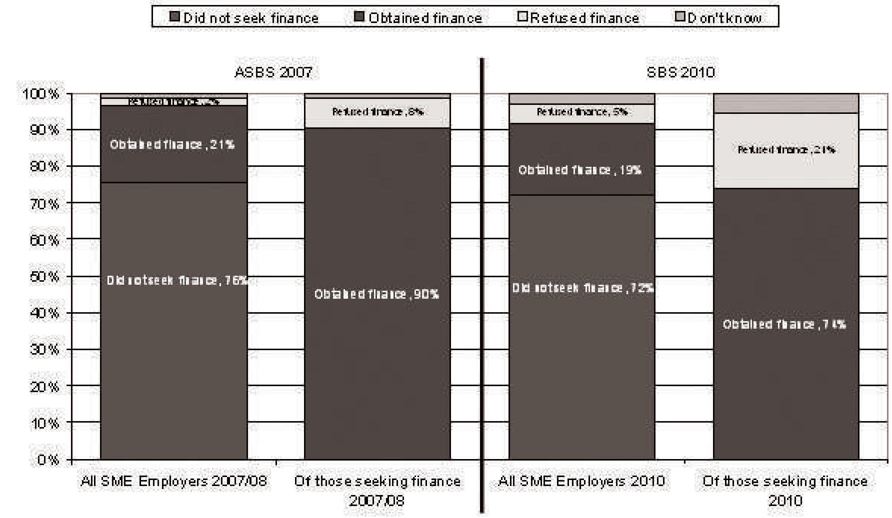
SMEs demand for bank finance is down with SMEs taking steps to reduce their reliance on external debt. Demand for credit remained muted because SMEs are cautious about business prospects in an uncertain economic environment. There is strong evidence to show SMEs are repaying existing debt and building up cash deposits.

Most SMEs that do not seek finance are content that they are not borrowing. However, there is a small but significant proportion of SMEs that are discouraged from applying for finance because they think they will be rejected. The November SME Finance Monitor survey estimates around 40% of would be seekers (12%) of all SMEs are discouraged, and this is equivalent to around 5% of all SMEs that are discouraged from applying for external finance.

… As well as a contraction in supply

In the immediate years before 2008, the banking market was competitive with banks aggressively pursuing market share by offering loans to 'riskier' businesses, interest rates that did not fully reflect the risk of the loan and often waiving fees & charges. It is widely acknowledged that an increased sales culture developed within banks, causing bankers to become more sales oriented. Banks are now more risk averse, both due to the credit crunch and because they are required to be by new financial services regulations (e.g. Basel 3). These new rules require banks to hold more capital against certain types of assets. Although most businesses can obtain the finance they need (74% of those SME employers seeking finance over the previous 12 months managed to obtain some finance), it is now harder to obtain than in 2007/08 when 90% of those seeking finance obtained it. This is equivalent to 21% of SME employers that sought finance being unable to obtain any finance from any source in 2010. This is a significant increase from the 8% seen in the 2007/08 Annual Small Business Survey. This is shown in the graph below, which also shows how many SME employers were affected in the SME employer population.

Proportion of SME Employers seeking and obtaining finance (2007-2010 comparison)



Source: Small Business Survey 2010

Equity finance is an important source of finance for high growth potential SMEs

Although only around 1-2% of SMEs looking for external finance seek equity finance (also known as “risk capital”), it is especially important for those early stage businesses with the highest potential for growth. However, the venture capital market has been heavily affected by economic conditions with a 31% decrease in the value of investment in 2010 compared to the previous year. Venture capitalists mainly invest other peoples’ money through established funds into high growth potential businesses.

Business angels have become an important source of equity finance to SMEs

Over the last decade business angels, have become a more important source of funding for early stage businesses and now supply a similar amount of equity finance to SMEs as venture capitalists.

Business angels are high net worth individuals that invest their own money in small growing businesses through an equity stake. Business angels are an important source of finance for SMEs. They tend to make smaller investments and so target the lower end of the equity gap not served by venture capitalists. Investments are predominately in small, early stage companies and there is also a strong focus on investments in technology companies.

The use of asset-based finance has also increased

There has been an increase in the use of other types of SME finance including asset-based finance. Factoring and invoice discounting can improve business cash flow by providing finance secured against unpaid invoices. The lender usually pays the business a percentage of the invoice. When the invoice is paid, the business will receive the balance, minus any charges. The level of finance advanced to an SME therefore varies directly with changes in their order books.For factoring, it is the lender, rather than the SME, that collects payments and pursues late payments. For invoice discounting the SME continues to manage its own sales ledger and debt collection. Over the last few years, there has been a significant growth in the amount of finance advanced through factoring and invoice discounting. As per the SBS survey, during Q2 2011 a total of £115 billion of clients' invoices were advanced, 14% higher than a year before. This is largely due to increasing sales as the number of businesses using this type of finance (41,500) did not change compared to a year ago.

Part Three

SME Sector in Pakistan

Student Learning Outcomes

By the end of this chapter you should be able to:

- **Discuss the importance of SMEs in Pakistan.**
- **Explain the role and contribution of SMEs in the socioeconomic development of Pakistan.**
- **Explain the present structure of SMEs in Pakistan and their future prospects.**
- **Discuss the conventional and emerging industry/sector concentrations of SMEs in Pakistan.**
- **Identify and describe the challenges faced by SMEs in Pakistan.**
- **Discuss the regulatory complexities that exist for SMEs in Pakistan.**
- **Discuss the impact of lengthy documentation procedure on obtaining financing for SMEs.**
- **Discuss the problems faced by SMEs due to shortage of equity sources and difficulty in obtaining financing facilities due to their in ability to meet credit criteria and inadequate bargaining skills.**
- **Discuss the impact of lack of proper infrastructure, quality control problems and lack of entrepreneurial expertise on the performance of SMEs in Pakistan.**
- **Explain the role of specialized institutions for development of SMEs in Pakistan.**
- **Describe the popular business models used by SMEs in Pakistan.**

The role, importance and contribution of SMEs in the socio-economic development of Pakistan

Small and Medium Enterprises constitute a very heavy portion of Pakistan's economy. According to the Federal Bureau of Statistics (FBS), there are around 3.2 million establishments in Pakistan that fall under the category of SMEs. According to the Small and Medium Enterprises Development Authority (SMEDA), "SMEs constitute nearly 90 per cent of all the enterprises in Pakistan; employ 80 per cent of the non-agricultural labor force; their share in the annual GDP is approximately 30 per cent and they contribute 25% to the country's total export earnings while their share in value addition is 28 percent.

All these statistics indicate clearly the crucial role of SMEs in the economic growth of Pakistan and foretell their untapped potential. One of the most interesting indicators is that SMEs contribute significantly to industrial employment which indicates industrialization potential. A dynamic and vibrant SME sector will provide sustainable growth and generate jobs, reducing poverty levels. SME development is pivotal for pro-poor growth because it makes possible the transition from low to middle- income status. In a nutshell, they function as catalysts of economic change and in many developed and developing economies, have been pioneering new technologies and management methods. Thailand, Turkey, India are just a few of the developing countries that have made swift progress in encouraging and fostering their SME sector.

There are a number of factors responsible for the importance of SMEs in a developing country like Pakistan:

1. They foster an entrepreneurial culture and provide resilience in the economy.

2. They contribute to exports, for example in Pakistan, SMEs dominate the fastest growing export sub-sectors, such as cotton weaving and surgical instruments.

3. They are an important vehicle for poverty reduction through employment generation and they constitute an importance source for technological innovation.

4. Sectors dominated by SMEs facilitate learning geographically and across the sectors. These sectors tend to generate higher levels of competition and mobility, which in turn forces highe levels of learning among firms. This is useful for diversification of the economy.

5. Their efficiency in resource allocation is higher socially in that they provide more employment at lesser capital costs

compared to large enterprises. For instance, the Ministry of Labor,Government of Pakistan had estimated that an addition of 16 million persons to the labor force would require an investment of Rs. 5.2 trillion in large scale sector while only Rs. 8 billion in the small/micro scale sector. In the medium scale sector the cost would be Rs. 0.8 trillion.

6. They help the economy by creating competition in the market place leading to multiplicity of choice and better pricing for goods and service

7. They contribute to reducing inequalities in the economy by distribution of wealth. It is, therefore, imperative for the future economic growth of developing countries to create and promote an environment that nurtures and facilitates the small and medium sector and enables it to realize its true potential.

Present state of SMEs in Pakistan

SMEs have over the years played a pivotal role for the economy as a whole by providing employment and facilitating the transition of the lower income groups into middle and higher incomes. Thus, inherently they have the ability of bridging the financial divide by eliminating socio-economic inequalities in the country. It has been empirically proven that no country has been able to achieve economic growth without active participation from the SME sector. While an overwhelming percentage of Pakistani businesses are SMEs, the performance of SME sector has remained dismal and has contributed to low performance of larger businesses as well. Since there is a direct relationship between the health of SME sector in an economy and the overall strength and growth of that economy, the poor performance of Pakistani SME has been one of the main reasons for the poor performance of the country's economy. Being the primary suppliers to most exporting firms, or being exporters themselves, performance of the SME sector is a significant determinant of the overall performance of any economy. Developed economies such as the Organization for Economic Co-operation and Development (OECD) members are marked by robust and vibrant SME sectors while developing and underdeveloped economies have weak and frail SME sectors. Since this sector also provides a major share of total value addition and industrial employment in almost all economies, its contribution to the industrial development and growth remains unarguable. The Economic Survey of Pakistan (2005-06) states that "Nothing portrays the reality of Pakistani business environment better than ... its SME sector". The better the SME sector performs; the higher the quality of goods and services produced in Pakistan.

SME Sector of Pakistan

Total Number	3,200,000
As percentage of total businesses	99 %
Share in industrial employment	78 %
Share in value addition	28 %
Manufacturing exports earning	25 %
Contribution to GDP Over	30 %
Exports value	Rs. 140 Billion

**87 % employ less than 5 people
**98 % employ less than 10 people
Source: Economic Survey of Pakistan – 2007-08, SME Policy, Pakistan, 2006.

The State Bank Governor while presiding over the 4th meeting of the SME Credit Advisory Committee talked in detail about some alarming trends emerging in the banking front and lending to SME's. "In percentage terms, the share of SMEs financing in the total lending portfolio of banks has also fallen from 16.2 % in Dec-2007 to 7.7 % by Sep-2011. Clearly, this is not a very desirable situation." he said. Most importantly, Governor SBP highlighted that while Banks have been financing SME's for working capital loans there has been a reluctance to provide long term financing to them.

Advances to the SME sector have shrunk too with total outstanding advances to SMEs standing at Rs334 billion as of December 2010, which according to estimates is the lowest in five years. The deteriorating macroeconomic conditions of the country have not helped either with SME's struggling to cope with the power crisis that is taking a toll on their production and performance. Therefore, while banks need to encourage lending to the SME's, other stakeholders cannot be excluded from blame in suppressing the development of these enterprises. With Non Performing Loans (NPLs) going from bad to worse, and an overall economic recession, banks are choosing for more risk free options like government securities. NPLs for SMEs reached 29 % in December 2010, thus explaining the reluctance of banks to finance small enterprises.

Notwithstanding the infrequent surveys of SME sector in Pakistan, the number of such units, especially small, is probably much larger than is officially reported. The surveys normally cover those firms that are registered and a large number of very small firms go unrecorded because they seek to remain hidden or the enumerators are not fully motivated to include them in the data. Most of small firms in Pakistan are very small, with limited employment

potential and little chance of growth; their primary concern is survival. In general, the firms with relatively more workers are smaller in number and those with smaller number of workers are in majority. Moreover, most of the firms are owner-managed, supported by family workers. The hired workers are few and found mostly in growing firms.

Female Managed SMEs

Some of the urban SMEs are also female owned or managed. As we move across income groups and firm sizes, the motivating factors of the businesswomen tend to change. In the subsistence income group, she acts as a wage earner. The lower income groups operating micro and small enterprises are also wage earners but mostly produce for an intermediary. The medium income groups operating micro and small firms tend to be retailers and rely on out sourcing for production; their main concern is generation of income and improving their standard of living. Like in so many other countries of Asia and Africa, Pak female owned/managed businesses are concentrated in selected sub sectors like fashion designing, dress-making, knitting, cane work, and food retailing. These activities are mostly home-based and thus go unrecorded in the official statistics.

Challenges faced by SMEs in Pakistan

1. Lack of proper infrastructure:

Infrastructure is very important for the growth and life of the small enterprise. Currently, the progress of SMEs in Pakistan is greatly hampered by weak infrastructure, insufficiency of electric power, high costs of energy, water, poor roads and transportation system, market facilities and industrial space. Other infrastructure deficiencies such as lack of information communication technologies (ICTs), lack of access to finance (financial infrastructure), poor educational infrastructure, insecurity of lives and property, among others, have become a source of concern to the growth and development of SMEs in Pakistan.

2. Regulatory complexities:

Regulatory constraints also pose serious challenges to SME development. The high start-up costs for firms, including licensing and registration requirements, can impose excessive and unnecessary burdens on SMEs. Businesses face a complex legal, tax and administrative environment in Pakistan, so every firm is anxious to avoid economic obligations associated with the registered status. For example, among the five major types of business structures

(sole proprietorship, partnership, companies, cooperative societies and non-profit associations (trust, etc), the first is the most common in Pakistan. This form particularly suits small businesses for reasons of costs, low complexity and the ease of compliance with regulations. The sole proprietorships and unregistered partnerships do not legally require registration or prior approval from any Government department or agency. However, this type of organization does not absolve them of obligation to meet labour, taxes and other regulations. In the case of partnership too, the firms prefer to remain unregistered partnerships, a status which confers freedom from compliance of laws. The unregistered status of these small firms has a negative impact on their access to institutional finance, yet they prefer to remain in informal sector. Compliance of labour laws is prohibitive in terms of time and money. Therefore, small units prefer to work in the informal sector or try to avoid registration under multiple laws, which are prohibitive for businesses.

3. Shortage of skilled manpower:

The economic performance of SMEs of Pakistan is negatively affected by the insufficient managerial skills, especially of the small firms. The foremost cause of low management skills of SMEs is the low educational and professional training of the business managers. In particular, SME managers lack the expertise for adequate bookkeeping, marketing, cost accounting, stock management, production scheduling and quality control. The managers are unaware of the importance of assets valuation and in some cases even adopt personalized management style, all resulting in low economic efficiencies.

Moreover, like all less resourceful firms, the SMEs due to their skill deficiencies are unable to compete with larger firms' better-qualified manpower. Inter-firm transfers of skilled labour is a usual phenomena directly influenced by relative wage levels. In this respect, the larger firms have advantage over SMEs, especially in a situation of skill shortages as is occasional in Pakistan as a result of migration of labour to Middle East and other countries.

It is worth noting that, contrary to the common perception, there is a hierarchy of skills within each category e.g. (mason, plumber, electrician) as per the skill level and they are paid accordingly. As a matter of fact, an excellent worker would get a premium wage from a larger firm which a SME may not

find feasible to pay. Hence, a smaller firm may suffer because of limited funds despite its need for high skilled workers.

4. Quality control problems:

There are no industry standards and quality control measures being followed in majority of the SMEs in Pakistan. Being resource constrained by nature, they usually cannot invest in formal certifications and establishment of Quality Management systems. Very few SMEs adhere to some type of standards or formal quality standards and most SMEs have minimal quality systems in place. Thus their product quality is either not being ensured, or is being ensured through informal phenomenon. There is, therefore, a great need to develop better quality control procedures in Pakistani SMEs to ensure competitiveness of their products in local and international markets.

5. Lack of entrepreneurial expertise:

Entrepreneurship skills are necessary for organizing, leveraging and managing resources for the creation of a new venture. A portfolio of entrepreneurship skills is required including risk assessment, strategic thinking, self-confidence, networking, motivational and other skills. SME entrepreneurs often lack skills across a number of the relevant areas. They are not adequately trained in international marketing, and lack information on trade contacts and business opportunities. Rather than in the area of small business management skills, such as business planning and accounting, the major gap appears to be in the area of strategic skills associated with entrepreneurship, including decision-making, risk-taking, information processing, opportunity recognition, resource organization, market awareness and product management.

6. Lack of separation of ownership from control:

The most important feature of family-owned SMEs is the lack of separation of ownership from control implying that directors and managers cannot be distinguished. This leads to credibility problems, as there is no system of checks and balances between shareholders, directors and managers. The duties and responsibilities, and privileges of family members are not clearly defined. Usually in small family-owned firms, the family has the requisite voting power to unilaterally

dismiss boards or management or to over-rule their decisions. Thus, the concept of independent directors does not prevail in these firms. The family usually wants to retain control over the business and view directors with apprehension. The approach of family owners is that they see anything external with threat. It is for this reason that they are not easily convinced to go for external financing. Other issues for family- owned businesses include:

- Absence of clear policies and long term planning.
- Lack of knowledge on strategic direction.
- Benefits and compensation for family members are not clearly defined.
- Hiring family members who are not qualified or lack the requisite skills and abilities to run the organization.
- They usually do not have a succession plan.

In South Asia region, family-owned businesses are an important component of the economy. According to SME Pulse, more than 80 percent of the company owners are also the management heads. A high percentage of them (about 98 %) handle decisions related to all aspects of management and governance in their companies themselves. More than 96 % of the owners take strategic decisions themselves while 89 % of the owners take decisions regarding day-to-day affairs, showing a high level of control. Results of the survey show that most of the SMEs are single person ownership firms.

7. Shortage / irregular availability of financing facilities:

Access to equity and finance is a major constraint to SME growth in many developing countries. The existing structure of financial sector only serves large enterprises and commercial banks usually apply conservative policies while lending to SMEs. Majority of the banks consider lending to SMEs an unattractive venture due to a range of factors including information asymmetries and consequently high transaction costs, collateral requirement, financial products not meeting SME sector requirements in medium to long term. Credit rationing which is a major constraint to growth is an SME specific constraint that is not binding on large firms.

On the supply side, weak creditors' rights because of inefficient legal system and weak governance structures of SMEs lead to information asymmetries resulting in higher transaction costs. The responsibility for the supply side falls on the government and financial institutions. The government through its policies and regulations introduced by the central banks has been encouraging financial institutions to increase their lending to SMEs. Pakistan has a fairly developed financial system spread across the country. Moreover, specialized financial institutions for support of SMEs have also been developed. These include the following: SME Bank, (established 2002), Khushali Bank, (established 2000); The First Micro Finance Bank etc. In addition, all commercial banks have the mandate to provide credit to SMEs and they are in the process of developing their special schemes. The Prudential Regulations of the State Bank have encouraged the banks to give credit to SMEs on the basis of cash flows rather than collateral requirements. Commercial banks have been encouraged to develop specialized SME departments in order to develop financial products according to needs of SMEs. Even with these efforts, the government has not been able to significantly increase credit supply by banks and coverage needs to be improved. Despite its immense significance and potential, the SME sector in Pakistan remains largely financially excluded, the current level of financing facilities to this sector stand at Rs 253 billion, constituting only 7% of the banks' total advances.

However, it is also important to look at this tendency from the perspective of demand from SMEs for financing. It has been observed that SMEs tend to shy away from formal modes of financing. According to SME Pulse, which is a survey of more than 600 enterprises in Pakistan, slightly less than half of the firms rely on loans to arrange running finance for their business. About 60% of working capital needs are usually met through personal investment or investment through other family sources while commercial banks contribute only 19% for short-term loans and 16% for long-term investment requirement. This confirms that SMEs do not resort to external financing unless it is absolutely necessary. External finance cannot be obtained by firms in their start-up phase as their management structures are not transparent and usually have intangible assets. At an early stage, an informal kind of financing is usually the main source. This includes owner equity (which then becomes retained earnings) or angel financing. Only when the firm is at an expansionary stage of

its business cycle that private finance is available through equity and debt as intermediated by venture capitalists and commercial banks.

Financing through public offerings of stocks and bonds are not available to these firms until they expand and build their reputation. In majority of the developing countries informal angel capital markets do not exist particularly for SMEs working in innovative sectors or developing innovative ideas. This is because high net worth individuals in these countries either opt for short-term profits or being risk-averse, tend to invest in safer sectors e.g. construction and real estate. This implies that SMEs would either need to resort to internal equity mode of funding or formal financing through banks.

Nevertheless, the formal financing through banks will come as the firm establishes itself subject to its governance. This will consequently help to graduate the firm to next level i.e. small to medium and medium into large. In addition to ownership structures, SMEs do not approach formal financing for the following reasons:

a. High cost of credit. With interest rates on loans beingquite high, and repayment periods relatively very short, SMEs are in a weak bargaining position and cannot be expected to flourish.

b. Documentation and procedures required for accessing formal finance are lengthy and cumbersome.

c. Long processing time.

d. Collateral requirements.

e. SMEs are mostly unregistered i.e. working in infomal sector and therefore would need to enter into formal economy and consequently face regulations.

f. Disclosure of taxes and burden imposed by inefficient tax authority.

g. Disclosure of information cause the firm to lose confidentiality vis-à-vis its competitors.

h. Perception that banks will start interfering in the internal affairs of the firm.

As per IFC survey:

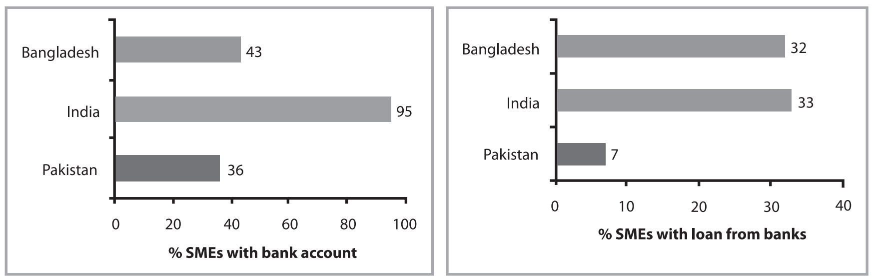
- Fewer than 200,000 SME's (7% of SME's) currently borrow from banks in Pakistan.

- SME lending has been on a downward trend over period from 2004 onwards accounting for 16% of total lending.

- This extends to financial service outreach also, with less than 40% SME's found to have any form of bank ing relationship currently.

- KFW survey estimates an SME funding gap of Rs 277 billion (current SME lending 400 billion) for small businesses alone, representing some 1 million SME unserved SMEs as a minimum.

Figure 3.1 : Access to Finance for SMEs in Pakistan, India and Bangladesh



Source: India ICA 2006 Manufacturing Enterprise Survey, Bangladesh 2006 Rural MSME Finance Services Survey, Pakistan KfW Demand Survey 2005

8. Shortage of equity sources:

A large portion of the SME sector does not have access to adequate and appropriate forms of credit and equity. SMEs in Pakistan face a lack of capital funds and financial resources because conventional banking and financial institutions are located mainly in urban areas and mega cities. There is immense potential in SMEs for development as it is still an untapped segment of the country, which has been neglected by the authorities for a long time, resulting in societal disparity on a vast scale, economic imbalance, inequality, and social discrimination between urban and rural inhabitants. As the foundation stone of these development polices was not laid with an ethical and balanced economic approach, hence the gap between rural areas and mega cities continues to widen at a very fast pace. A major constraint for the development of the small rural industries of Pakistan is the absence of financial linkage between those potential clients and the financial institutions.

9. Inability to meet credit criteria / credit conditions:

SMEs usually fall into the special risk category with banks because they usually do not have sufficient funds of their own, and often lack collateral or credit history, and they are therefore charged higher interest rates, reflecting the risk level. Commercial banks and investors have been reluctant to service SMEs for a number of reasons, including the following:

- SMEs are regarded by creditors and investors as high-risk borrowers because of insufficient assets and low capitalization, vulnerability to market fluctuations and high mortality rates;

- Information asymmetry arising from SMEs' lack of accounting records, inadequate financial statements or business plans makes it difficult for creditors and investors to assess the credit worthiness of potential SME proposals;

- High administrative/transaction costs of lending or investing small amounts do not make SME financing a profitable business. As a result, commercial banks are generally biased towards large corporate borrowers which provide better business plans, more reliable financial information, better chances of success and higher profitability for the banks and have credit ratings. When banks do lend to SMEs, they tend to charge them a premium for assuming risk and apply tougher screening measures, thus driving up costs on all sides. Commercial banks in developing countries and countries with economies in transition often prefer to lend to the government and thus the public sector crowds out the private sector. Although the business environment in developing countries and developed countries differs in many respects, the problems of servicing SME customers are similar, namely high-perceived risk, problems with information asymmetry and high administrative costs.

10. Lack of Technology:

Technological constraints constitute a formidable problem for the small, but much more for the medium firms. Traditional medium firms use the low-quality production methods, resulting in poor quality of their products. These firms rely

heavily on old technologies and replicate low-quality old products. Consequently, they do not find a niche in the world market for those products. The SME, in particular the small industries of Pakistan, are known to rely on low and obsolete technology. A typical Pakistani small firm uses indigenous machines of old-vintage and relies on traditional productions methods for survival. They end up producing low-quality, low-priced products. Associated with this is the lack of technical skills needed for producing quality products. There is a general absence of information on opportunities for technological up gradation. This drawback acts as a major barrier on road to knowledge-based modern economy. A part of the problem is linked to the inability of SMEs to acquire sophisticated equipment and research and development facilities. This is manifested in adoption of labour-intensive production methods associated with lower productivity levels and overall economic efficiency.

11. Fiscal and Taxation System:

There is sufficient evidence that local tax authorities harass small firms regarding assessment of income tax. This threatens entrepreneurs away from business and even causes revenue loss to the Government. Hence, the Government should involve local Small Businessmen Associations for assessment of individual firms' tax liabilities. This will get group support for tax collection and also ensure regularity in revenue collection. The real problem is the common practice of small businesses to avoid regular account keeping. The entire culture of small businesses is informal which seems to have seeped into the world of small enterprises. In contrast, large firms are offered concessions by government including exemption from tax payments i.e. tax holidays. Similarly, firms exporting goods produced by small units are given substantial tax rebates, but the producers do not receive any benefit for producing exportable goods. Thus, there are reasons for the parent firms to avoid payment of tax liabilities as a survival strategy.

12. Obstacles to accessing international markets and knowledge flows:

New firm start-ups and innovative SMEs increasingly operate in international markets, exposing them to foreign competition and providing them with new opportunities. At the same time, globalization is increasing the importance of cross-border knowledge flows about markets, suppliers and

technologies, which help to upgrade SME competitiveness and stimulate SME growth. Access to knowledge flows is particularly important in the context of the widespread adoption of open innovation methods in many sectors, involving collaborations between new and small firms and other firms and organizations in developing new products and services, new process technologies and new organizational models. Foreign partners can be particularly valuable in such knowledge exchange networks. Indeed, export orientation and active innovation networks are the core characteristics associated with rapid SME growth. However, SMEs are under-represented in the international economy. There are many barriers affecting the internationalization of SMEs and entrepreneurs. Many are internal to the SME: limited information on foreign markets and supply chain and technology partners, lack of managerial time for international engagement, lack of workforce skills and knowledge to access markets and collaborators and absorb innovation, shortage of working and investment capital to finance exports and deal with slow supply chain payment schedules and lack of sufficient product and service quality to meet customer requirements. Non-tariff barriers and poorly adapted framework conditions are further problems for SMEs, notably administrative and technical difficulties, exchange rate fluctuations, documentation and payment problems.

SME banking business models in Pakistan

Lending to SMEs picked up pace when Dr. Yunus in Bangladesh started his initiative of providing soft loans. Grameen bank reversed the practice of conventional banking by removing the need for collateral and created a banking system based on mutual trust, accountability, participation and creativity. It provides loans to the poorest in Bangladesh with little need of collateral. What is most impressive is that loan payback rate of Grameen Bank according to them stands at an outstanding 99%. With the deteriorating macroeconomic indicators, the cost of doing business in Pakistan has also been on the rise. This has been highlighted by many reports and studies recently conducted including that of the World Bank. In other parts of the globe, almost 12 % of SMEs have been able to evolve into Medium and eventually larger organizations. This can be attributed mainly to the conducive business environment in those countries.

According to SBP report, the slowdown in micro credit growth in the country was attributable to a number of factors that include, funding, high operating costs, credit risks, organizational development and external factors. Financing of lending operations

is limited, due to which the micro finance sector faced a difficulty in accessing commercial funds from risk averse commercial banks. High operating cost to loans ratio that is presently at 22 % also poses a great challenge of making microfinance a viable business product, the report states. The report mentions how lack of appropriate internal controls gave rise to the phenomenon of overborrowing by clients that created negative spillover effects. Inflation has also been highlighted as affecting the repayment capacity of micro-borrowers. Organizational development is also a prerequisite for sustainable growth. The report cites how these factors limit the potential of achieving the required levels of growth.

Finally, the report states that external factors such as challenging macroeconomic variables and volatile law and order are inhibiting the growth of the microfinance sector. The Grameen bank model has been adopted successfully by institutions in other countries as well, enjoying great success. CARD for instance is one of the largest Grameen replication, currently operating in Philippines. CARD has also had a recovery of credit rate of 98%. For the development of the SME sector in Pakistan a comprehensive approach would have to be adopted by all stakeholders, especially banks as also mentioned by SBP Governor, which can eventually improve the availability of finance and other relevant banking services for the SME sector. The model of success in other countries has been achieved via ensuring personal guarantees through collateral supervision, a lending approach based on cash flow, prudent lending measures, SME courts, and a relationship based on mutual trust. Segmenting and profiling of SMEs is a must that needs to be done in Pakistan.

The solution to the dilemma lies in adopting a multi pronged approach to the problem at hand. Firstly, there needs to be greater collaboration amongst SMEs and larger companies. Entering into sub-contracting arrangements will allow the SMEs to leverage the established track record and credit worthiness of larger companies. The dealings of SMEs with these larger companies will provide banks with ample information regarding their dealings with the larger companies and allow SMEs to grow and evolve as well. Secondly, the technical know-how, marketing, managerial, accounting, book keeping and preparation of financial services are often lacking in SMEs. This gap can be filled through social intermediation where intermediaries including the public, private or non-government entities can step in and fill the void. Taking this step will further improve the bankability of these entities with proposals and requests for fixed and working capital. While

SMEDA is already contributing in this regard, we need more such organizations to facilitate the sector.

Further, provincial governments must work to improve the quality and educational standards of the large number of vocational training institutes that on the one hand claim to produce skilled labour, however with the technical and professional know how lacking, leave the graduates redundant once they enter the labour force. Managerial and entrepreneurial training also needs to be provided in government and public institutions.

SME bank and other government lending institutions must make the documentation processes for availing loans easier through standardization and creating easy to fill documentation. Finally, more banks need to assign exclusive branches to deal with SMEs. This will enable these specialized bank branches to cater better to the SME clients through improving on the products and services with the constant feedback received from SME clients. Habib Bank has taken some brilliant decision in this regard by assigning branches to exclusively deal with the sector. International Finance Corporation (IFC), member of the World Bank Group, is helping Pakistani bank, Habib Bank (HBL) increase lending to small and medium enterprises (SMEs). IFC has helped HBL develop a new financial service, HBL Business Faida, designed specifically for small-scale entrepreneurs. HBL launched the service to provide such entrepreneurs access to financing so that they can expand their businesses and create jobs. IFC has also helped HBL develop a new business model for SME banking. The bank, with IFC assistance, initially is rolling out HBL Business Faida in the Lahore region, home to 45 % of the country's SMEs. HBL plans to launch the program countrywide through its extensive branch network.

Moreover Bank Alfalah and the State Bank of Pakistan (SBP) have also undertaken a joint venture under the DFID-funded Financial Inclusion Programme (FIP) that would lead to a sustainable, sound and integrated financial system, characterized with ready access to finance, diversified loan portfolio and extended outreach to SMEs. The main objective of the project is to create a symbolic podium, which can position Bank Alfalah to cater to the financing needs of the SME sector including the S and M segments through a holistic banking and advisory services solution.

SBP Governor said the SMEs need to be addressed through innovative credit assessment tools and techniques like credit scoring and capacity enhancement of the financial service

providers, and an integrated approach to SME Banking. DFID and SBP are keen to upscale FIP to reach out the unbanked segments in Pakistan. Going forward, FIP funds will also be targeted to improve financial inclusion through SMEs banking.

The role of specialized institutions for development of SMEs in Pakistan

In the last decade, several policy measures have been taken by the government in different countries for promoting SMEs and their activities. Since last decade, the government of Pakistan is continuously engaged in formulating and implementing policies to assist SME sector so that it can play its role in the economic development of this country. The government has tried to boost this sector's performance by establishing various institutions facilitating small business operations. It is clear that the government alone cannot succeed in its efforts to make this sector healthy and successful.

Institutions and other concerned bodies for small businesses emphasize the role of public private partnership to initiate various tasks including research and development (which is rare in this sector) to help entrepreneurs and owner-managers in better business operations management.

Several major ministries in Pakistan have the primary public responsibility for regulation and promotion of the SME sector, especially the Ministry of Industries, the Ministry of Commerce, and Ministry of Science and Technology. However, as they address a broad constituency, the bodies that are most directly responsible for SME development and promotion are:

- **The Small and Medium Enterprise Development Authority (SMEDA)**, which was set up in 1998 as the apex body for the promotion of SMEs in Pakistan, and is associated with the Ministry of Industries and Production. With a futuristic approach and professional management structure SMEDA focuses on providing an enabling environment and business development services to small and medium enterprises. SMEDA is not only an SME policy-advisory body for the government of Pakistan but also facilitates other stakeholders in addressing their SME development agendas.

- **The SME Bank**, which emerged from the restructuring and amalgamation of the earlier Regional Development Finance Corporation and Small Business Finance Corporation in January 2002 and which is mandated to support and develop the SME sector by providing the necessary financial and technical support on a sustainable basis. SME Bank provides lending products through loan facilities, asset finance, running finance, leasing, and tentative lending rates; and

banking products, including daily product basis, saving accounts, basic banking accounts, and current accounts. The company also provides project financing, working capital, and business support services to SMEs in Pakistan.

- **Conventional or interest-based financial institutions** for financing SMEs were setup in Small and Medium-Sized Enterprises (SMEs) in Pakistan in all four provinces of Pakistan. The names of these financial institutions are as followings:

    - The Punjab Small Industries Corporation
    - The Sindh Small Industries Corporation
    - The NWFP Small Industries Corporation
    - The Directorate of Small Industries, Baluchistan

- **Business Support Fund (BSF):** SME Business Support Fund (BSF) was established by the Ministry of Finance, Government of Pakistan in April 2005 and is administrated by an independent Board of Directors with majority of the members being from the private sector. It is a "Not for Profit Company" created to assist both SMEs as well as Business Development Service Providers (BDSPs).

    The objectives of BSF are to assist in the improvement of the competitiveness of SMEs and to enhance the revenue generating capacity and profitability of emerging businesses. BSF has the mission to make SMEs competitive and sustainable through innovation and efficiency.

    BSF has its Head Office in Lahore with state of the art infrastructure and an office in Peshawar to oversee operations in Khyber Pukhtunkhwa. It is in the process of opening offices in Karachi, a major industrial hub for SMEs, in Bahawalpur to tap into the potential of women entrepreneurs in Southern Punjab, in Gilgit Baltistan to explore new agri-business opportunities and in Islamabad for liaison with donors and other Government Institution.

    - **The Export Promotion Bureau (EPB) – now TDAP**, which is associated with the Ministry of Commerce and acts as a facilitator to help SMEs gain access to foreign markets.

    - **The Ministry of Science and Technology**, which provides significant support services within its field of competence to SMEs.

- **The National Productivity Organization**, which comes under the aegis of the Ministry of Industry and Production, and is affiliated with the Asian productivity Organization. It imparts productivity tools for SMEs in Pakistan as well as organizing training work shops on various topics related to SMEs.

- The network of **Chambers of Commerce** and Industry, which operates at both the local level throughout Pakistan and the national level through the Federation of Pakistan Chambers of Commerce and Industry (FPCCI). They play a pivotal role in conducting trade negotiations and creating linkages and between enterprises in Pakistan and foreign countries through their association with counterpart institutions in these countries.

All the commercial banks, along with the above-mentioned institutions, are also responsible for sanctioning capital funds to finance SMEs in Pakistan. They have the mandate to provide credit to SMEs and they have their own special schemes in place for this purpose.

Sector concentrations of SMEs in Pakistan

The Economic Census of Pakistan reports that nearly 53 % of all SME activity is in retail trade, wholesale, restaurants and the hotel business whereas the contribution of industrial establishments and those involved in service provision is 20 % and 22 % respectively. Among the SMEs involved in retail, wholesale and restaurant business, 98 % employ less than five persons and 99 % less than ten persons. The manufacturing and other sectors also follow a similar pattern with 87 % employing less than 5 persons and 98 % employing less than 10 persons.

A great deal of diversity can be seen in SMEs in terms of size, product lines, resource base, management structure, growth requirements and so on. The medium-sized units have their distinct characteristics. They are more resourceful, with better access to market and the supply side inputs, including technology. Accordingly, the two groups of firms, medium and small, are different in terms of their product quality and growth potential. The extent of diversity of SMEs can be gauged from the fact that they operate in the manufacturing, agriculture and services sectors at different production levels despite many institutional and firm-level constraints. Besides, they operate in urban and rural areas, though are concentrated more in the former. Despite their

heterogeneity, SMEs in Pakistan are generally concentrated in selected activities such as:

I. Metal working,

II. Furniture,

III. Agro-based,

IV. Sports goods,

V. Fisheries,

VI. Poultry,

VII. Gems and Jewelry and

VIII. Food and Catering

Even among small firms, the extent of variety in terms of production activities is very large. Depending on the type of activity, product, skill and technology required on the one hand and the level of demand on the other, a large number of SMEs operate in different sectors of the economy. Put together, the SMEs make a much more complex and diverse group of enterprises existing in different sectors of Pak economy. However, SMEs are not found in every industry, particularly where the economies of scale act as barrier to their entry.

Part Four

Financing of SME

Student Learning Outcomes

By the end of this chapter you should be able to:

- **Define the term SME borrower.**
- **Discuss the banking needs in terms of borrowing and related services (collections, payments and trade etc) for SME customers**
- **Differentiate between the nature and need of SME borrower and large corporate borrower**
- **Describe the role of banks in catering to the SME needs in Pakistan**
- **Discuss the nature and features of the financial products available for SMEs**
- **Analyze the financial products geared towards SME customers**
- **Discuss the need for organizing a sustainable program for SME financing through financial institutions**
- **Explain the services and banking advice required by SMEs**
- **Discuss the challenges in obtaining true financial statements from SME. Describe the use of informal / proxy techniques for arriving at close to real financial statements.**
- **Analyze the credentials of an SME in terms of the following:**
    - **Sponsor credibility**

Part Four

Financing of SME

Student Learning Outcomes

- Management depth and vision
- Business model
- Financial health
- Repayment capacity
- Ratio analysis
- Cash flow analysis
- Collateral

- **Analyze the operating ratios, debt / equity ratios, risk ratios, marketing / industrial / business norm ratios and/or preferred ratios for SME financing**
- **Explain the security collateral coverage and discuss the importance of personal guarantees for SME financing**
- **Discuss the important parameters of credit approval package for SMEs**
- **Discuss the role of scorecards in SME lending**
- **Describe the important components of a scorecard. Also explain the challenges that exist in using this credit scoring technique**

SME borrower

The term 'SME borrower' refers to the small and medium sized enterprise, which requires financing for its operation. Finance to the SME borrower is supplied through the business finance market in the form of bank loans and overdrafts; leasing and hire-purchase arrangements; equity/corporate bond issues; venture capital or private equity; and asset-based finance such as factoring and invoice discounting. However, not all business finance is external/commercially supplied through the market. Much finance is internally generated by businesses out of their own earnings and/or supplied informally as trade credit that is, delays in paying for purchases of goods and services.

Banking needs of SME customers

Banks play an essential role in the business operations of small- and medium-sized businesses, meeting their diverse financial needs to drive innovation, development and growth. The majority of bank business customers are small businesses and banks work hard to meet the needs of this market – one that is increasingly competitive, diverse and technologically savvy. In fact, all banks have dedicated small business departments to help their SME customers. Bank service of the SME sector is economically valuable because of the sector's importance in each country. In low-income countries, the role of banks may be critical if the prospect of bank financing can create enough incentive that informal firms will register as SMEs in order to receive loans.

Unmet Demand for Banking Services

Despite the recognized importance of the SME sector, evidence indicates that SMEs continue to be undersupplied with the financial products and services that are critical to their growth. In global surveys, including the World Bank's Enterprise Surveys and Investment Climate Assessments, SMEs report that the cost of finance is their greatest obstacle to growth and rank access to finance as another key obstacle. While these constraints are more acute in developing countries, SMEs in any environment are nearly one-third more likely than large firms to rate financing constraints as a "major" growth obstacle. In low-income countries, this means that nearly half of small firms report being severely constrained by financing difficulties.

Complaints of financial constraints by firms may not be completely reliable indicators of what SMEs actually face but data from these surveys also show that SMEs actually use external financing to a much lesser degree than large enterprises. For example, even though bank financing is consistently the most important source of external financing for small firms, large firms

are 150 % more likely than small firms to use bank financing for a new investment.

SMEs are particularly in need of bank services because they lack the cash flow to make large investments, they cannot access capital markets as large firms can, and they often lack qualified staff to perform financial functions. Here, bank-provided long-term debt can enable SMEs to invest in expansion without losing ownership. In addition, short-term and working capital loans help SMEs grow incrementally. Lastly, bank deposit and transaction products can improve operational efficiency and enable SMEs to outsource financial functions.

Long-term financing products, such as term loans with longer maturities and fewer restrictions on usage provide SMEs with investment capital for strategic business expansion — for example, through research and development, or property and equipment purchases. SMEs may have difficulty obtaining these types of loans because of inadequate financial records or assets to use as collateral. While some banks offer unsecured loans to SMEs, based on cash flow rather than collateral, these loans often come with shorter maturities; in general, collateral requirements have been the norm.

Partially due to this, long-term finance is one of the most commonly cited needs of SMEs and in many aspects, long-term loans are where the “missing middle” problem has been most acute, especially in developing countries. Bank products can also enable SMEs to take on more and larger contracts. A small or medium enterprise may have a potential order from a customer in place but need cash up front to complete the order. Banks can provide short-term working capital to such SMEs to purchase supplies, pay employees and meet obligations to clients. Providing help with order fulfillment can extend across borders as well, with trade financing assistance. For example, with a letter of credit, exporting SMEs can offer customers better payment terms because a bank pays the enterprise based upon documentation of the sale and extends credit to the customer of the enterprise.

Finally, SMEs have important operational needs that banks can meet with non-lending products that include deposits and savings, transactional products, payments facilitation, day-to-day cash management services, foreign exchange, records management, advisory services and business succession planning. Some of these products can effectively enable SMEs to outsource financial functions to the bank.

- **Deposit and savings products:**
  Deposit and savings products provide businesses with basic financial management tools to help organize revenues and savings. Additionally, mutual funds and other investment products provide businesses with opportunities to obtain earnings on excess capital.

- **Transactional products:**
  Transactional products facilitate SME access to and use of available cash. Automatic payroll and payment collection, debit cards and currency exchange are transactional bank offerings that lower the cost of doing business and streamline potentially complicated processes.

- **Money transmission:**
  Money transmission services are provided by means of business current accounts which give SMEs instant access to their money and which offer a range of specific money transmission facilities (eg cash and cheque deposit, cheque writing facilities, direct debit, and standing order facilities). These are core products for which there are no substitutes. A handful of banks are the only significant suppliers, and they in turn together control the wholesale networks for many transaction services. Moreover, SMEs often need a current account transaction history in order to secure reasonably priced debt.

- **Advisory products:**
  SMEs can benefit from help in producing reliable financial statements, developing business plans and selecting appropriate financing products. These advisory services can improve SME access to finance by enhancing its capacity to apply for credit.

Non-Financial Services Offered to SMEs

- Information Services: Self-help knowledge delivered to SMEs via websites, publications, business centers, or interactions with Account Managers.

- Training Services: Interactive activities designed to facilitate the learning and development of new and existing skills and to improve performance.

- Consulting Services: Direct interactions with knowledgeable experts to gain insights and expertise (can be in the form of counseling or mentoring).

The role of Pakistani banks in catering to the SME needs has been covered in detail in module 7 of this book.

Assessing Bank Service Offerings
Typology & Examples of SME Non-Financial Services

Account Manager Support	Information Dissemination	Training	Consulting Services
Tools/Services	**Tools/Services**	**Tools/Services**	**Tools/Services**
• Advice and business assessments from Account Managers	• Computer software and web based SME information platforms (e.g. IFC SME Toolkit or B2B Platform) • Trade fairs • Road shows • SME Expo series • Reality television shows • SME Excellence Awards • Networking events • Sharing industry specific publications and media articles • Negotiated discounts for business solution providers (e.g. software)	• Workshop/seminar training through Business Clubs • Training through IFC Business Edge • Training referrals to training institutions, IT firms, nonprofits, universities, etc. • Specialized training programs for women SME owners ("IFC GEM")	• Advice and guidance through Business Clubs or through partnerships with business mentors/coaches

The State of SME Banking Today

SME banking is an industry in transition. From a market that was considered too difficult to serve, it has now become a strategic target of banks worldwide. The "missing middle," describing the gap in financial services provided to SMEs, is shrinking. SME banking appears to be growing the fastest in emerging markets (low- and middle-income countries) where this gap has been the widest. More and more emerging market banks are developing strategies and creating SME units. Competition in other markets is one reason cited for commercial banks moving "downstream" to serve SMEs. Also, governments around the world now recognize the importance of the SME sector and have worked to support its access to finance, sometimes by addressing legal and regulatory barriers or building credit infrastructure. But the key to the growth of SME banking may be that banks are starting to understand the particular needs and preferences of SMEs and are developing tailored approaches to overcome the historical challenges of high credit risk and cost to serve. One sign that banks are unlocking some of the potential in the market is that they are reporting higher returns on assets from their SME operations. For example, leading banks reported ROAs of 3–6 percent for their SME operations compared with 1–3 percent bank-wide.

Also, contrary to common perception, the SME market is served by a wide spectrum of banks, not just smaller banks with relationship-based models. Today, despite the significant challenges posed by the global economic crisis (2008-2009) and

the uncertainty ahead, many banks seem to be holding fast to their strong commitment to the SME sector, especially in emerging markets. While the full impact of the crisis is not yet apparent, banks maintaining their focus on SMEs often cite a strong belief in the importance of the SME sector to the national economy as a whole.

Bank Approaches to the Challenges of Serving SMEs

To effectively serve SMEs, banks have had to change the way they do business, and manage risk, at each stage of the banking value chain. This begins with working to understand the market, and how it differs from both the retail and commercial segments. Next, in developing products and services, banks have begun to understand that SME banking means much more than SME lending and are, therefore, prioritizing non-lending products in order to provide total customer value. Leading banks report that more than 60 % of their SME revenues come from noncredit products. Banks have found ways to manage both costs and credit risk as they acquire and screen clients. A bank's current portfolio provides both a low-cost starting point for generating new business and a source of valuable data that can enable it to understand and predict the risks associated with SME clients. Developing this capacity to predict risk without completely reliable financial information, by using tools such as credit scoring, has enabled banks to more effectively screen potential clients. In serving SME clients, banks are improving efficiency by using mass-market approaches for smaller enterprises and using direct delivery channels where appropriate. They also build their revenue base by prioritizing cross selling to existing clients. Finally, banks are adapting IT and MIS tools, and building capacity to effectively use these tools for managing information and knowledge in their service of the SME market, especially in understanding profitability and risk.

The experience of individual banks such as ICICI Bank, Wells Fargo and Standard Chartered demonstrate innovative approaches to SME banking. Some of these innovations include multi-level service segmentation and creative involvement in equity financing of SMEs.

How to Begin Engaging the SME market

Banks looking to enter the market or expand their SME operations will be able to draw from the lessons of other banks' experience to date. These lessons apply to operations in five strategic areas:

(1) Strategy, SME focus and execution capabilities;

(2) Market segmentation, products and services;

(3) Sales culture and delivery channels;

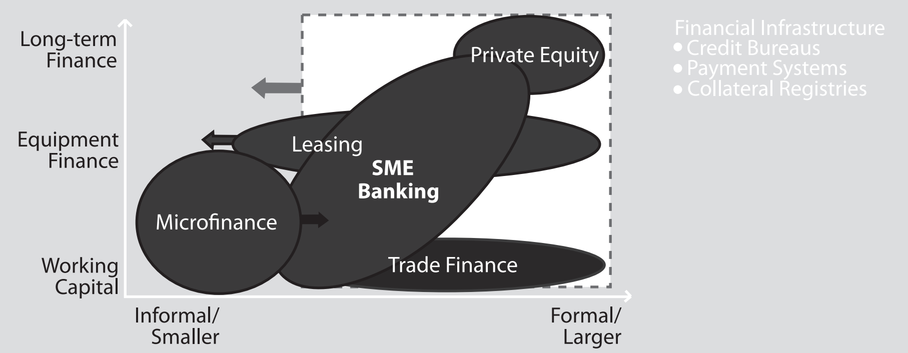
(4) Credit risk management; and

(5) IT and MIS.

Before putting these lessons to use, however, banks need to follow a process for market entry that begins with understanding the specific opportunity in the SME sector and ends with developing a strategy and implementation plan. Two tools that facilitate this process are a market assessment and an operational diagnostic. A market assessment is concerned with determining the size and nature of the opportunity as well as the competitive landscape. An operational diagnostic helps highlight a bank's strengths and weakness. IFC's SME Banking CHECK Diagnostic Toolkit is an operational diagnostic built upon the five strategic areas of SME banking.

In summary, serving SMEs is proving to be profitable and rewarding for individual banks, and assisting the growth of SMEs will benefit national economies as well. Banks looking to seize opportunities in the market can use this Guide as a means to learn from industry experience to date. By debunking misconceptions of SME banking, establishing its business case, and sharing global good practices, the SME Banking Knowledge Guide hopes to support banks in building stronger, sounder services for small and medium enterprises worldwide.

Figure 4.2: SME banking covers a wide range of firm sizes and types of financing



Developing Products and Services for SMEs

As explained earlier, a bank's product and service offering includes, but is not limited to, lending, deposit, and transactional products. The breadth of the offering is important because it impacts a bank's SME market share by drawing in new clients or securing more business from existing clients. The design of products and services also impacts the profitability of serving the SME market. Lastly, effective product development can influence the size of the addressable market itself by enabling banks to reach

clients that would otherwise be uninterested or unable to meet requirements for service.

There are three main challenges in developing a product and service offering geared toward the SME client. The first challenge is to develop a set of products that are bundled in a compelling way that persuades the SME client, who may bank with multiple institutions, to bring all their business to one institution. Products and packages that increase "share of wallet" and meet a range of customer needs help banks establish a portfolio of high-value, loyal clients.

The second challenge is to ensure overall profitability across the offering, recognizing that SME-specific data is difficult to gather, particularly at the product level. This challenge is also complicated by the fact that the role of one product in securing the rest of an SME's banking business may be uncertain. Furthermore, while revenues from a particular product may be easy to observe, the costs to provide it may be difficult to disaggregate.

This assessment is made even more difficult when information about the SME portfolio only reflects a fraction of the product offering. For example, a bank serving SMEs in the Middle East found it difficult to assess SME profitability because centralized data was only available for loan products, while the profitability of non-lending products was tracked at the branch level and was often not disaggregated for SMEs. Surveys of banks in Argentina and Chile found that "almost half of the banks do not keep track of the revenue share arising from deposits/account management, credit and other transactions, and fee-based services to SMEs."
A third challenge in developing a product and service offering is to strike the right balance between increasing one's offering to appeal to a broader market and recognizing one's limitations in the bank's capabilities. This is particularly true with lending products, where new product designs have the potential to make financing available to SMEs, for example, that cannot provide collateral in traditional forms. New means to secure lending or new ways to provide unsecured loans, can increase market size by tapping into the vast unmet demand of SMEs lacking collateral and by fostering the growth of SME clients. However, the design of new lending products(including their pricing, contract, and monitoring structures) must reflect a careful assessment of the cost and risks to offer them.

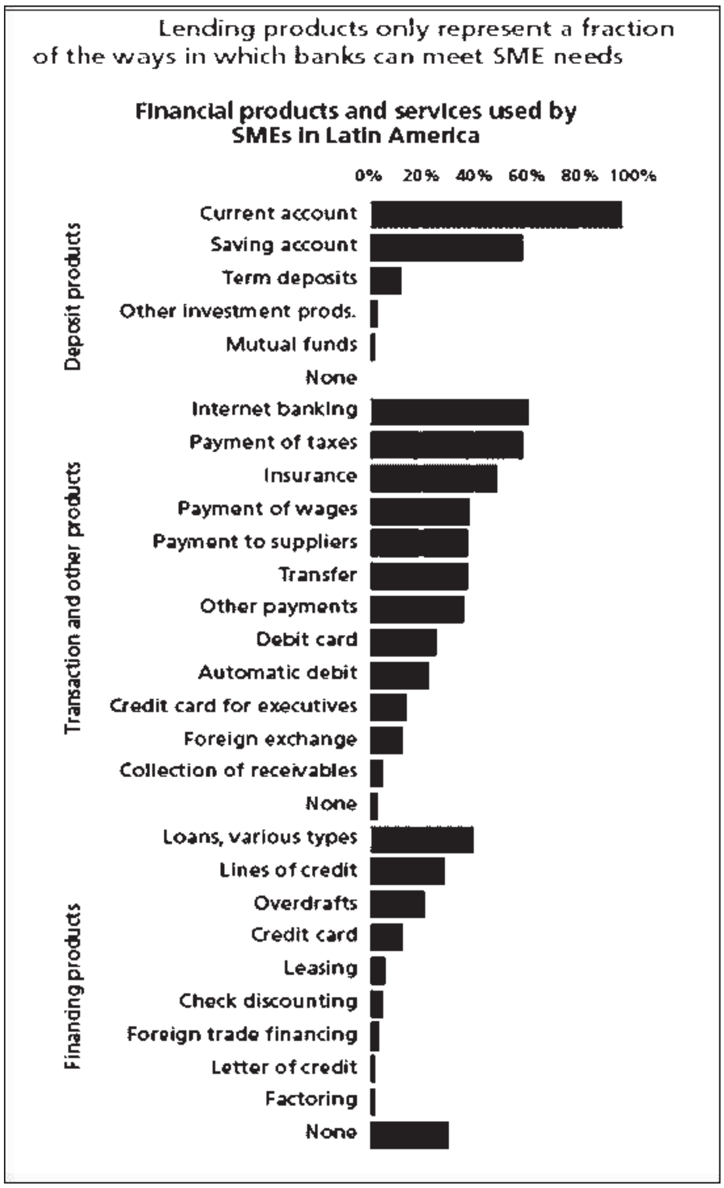
Approaches

Developing an effective product offering may begin with

understanding the scope of products and services banks can offer SMEs. While lending is a central offering in SME banking, the ways in which banks can meet SME needs extend far beyond lending.

The figure below illustrates some of the bank products and services used by SMEs. Although this data is specific to Latin America, it provides an overview of products that is largely relevant across regions worldwide. It shows that SMEs use a current account more than anything else, that many rely on banks for payment and other transactional services and that financing itself can come in many forms besides standard loans.   This list of products is consistent with what banks may offer SMEs throughout the world, though in fact it understates the potential offering by not including such product categories as advisory services, which are increasingly common, or equity financing, which is only recently emerging.

Figure 4.3



Deposit and transaction products are worth highlighting as they are often overlooked, despite demand expressed by SMEs. Deposit products offered by banks have not traditionally been tailored to SME needs but have been provided as a standard set of current and term deposit accounts. Transaction products have similarly been limited, as banks have traditionally viewed them as low margin and therefore, less attractive. However, technology developments such as internet banking, electronic clearing and document management have increased the appeal of transaction banking products to SMEs while generally lowering costs for banks over the medium-term. Transaction products are particularly valued by SMEs who are less likely than corporate clients to have the in-house capabilities to manage wage and supplier payments, taxes, receivables and other critical transactions.

Banks have found that SMEs are more likely to be loyal clients when they feel the breadth of their needs have been understood and met. Increasing wallet share and customer loyalty, therefore, depends in many cases on raising the number of products used by each SME customer. Banks may track this statistic as a key measure of their overall effectiveness. For example, Wells Fargo has targeted eight products per customer for each of its customer segments. While a large part of expanding wallet share involves integrating cross selling into the strategy for acquiring and serving clients, developing the product offering plays an important role as well. To effectively maximize and retain the business of SME clients, banks are:

(1) developing a wide range of products suited to different SME needs and

(2) learning to bundle products and services.

IFC's Benchmarking study of leading banks found that many had originally started with a limited product offering, especially to small businesses but expanded their range as their understanding of the market grew. In addition, they reported plans to continue adding new products in response to SME needs. OECD banks from this study reported providing about three credit and three deposit products to each of their SME clients in emerging markets, that figure is closer to two of each type. By selling products in packages, or bundles, some banks have found that they can use one product that meets a top priority need to secure the sale of another, such as using a loan to gain an SME's deposit business. Bundling also appeals to the commonly reported desire of SMEs to minimize the time it takes to conduct banking business.

While bundling can increase market share, its impact on profitability depends on the cost and revenues associated with each product. Many banks are limited by the lack of data but leading banks are working to track and analyze the information they need to assess the profitability of all the products offered to SMEs. They report, for example, that revenue from credit products represents only a fraction of total income from SME clients. Since deposit and transaction products can often be provided at lower costs than loans, this explains why it might be worthwhile to provide a low-value loan to an SME if it is linked with other, more profitable products. Cross subsidization of this sort is one way that banks have been able to increase the size of the addressable SME market and lend to SMEs that previously may not have warranted a loan.

Another way they have opened up the market is by incorporating new lending technologies into their loan offering, in particular those that address the problem of collateral. Traditionally, SMEs have lacked the types of collateral needed to secure loans when available information about their credit worthiness was not sufficient. This has been especially true in the developing world where property rights are weak and collateral requirements may be very high. Even when such collateral is available, its use may place finite limits on SME growth, ultimately reducing the market for lending.

To overcome this, banks have found new ways to lend using nontraditional, growth-oriented means of securing loans. At the simplest level, this can mean using collateral that is linked directly to the investment or expansion of an enterprise, as in equipment leasing, or asset-based lending where accounts receivable become collateral. A more sophisticated product is factoring — a form of trade credit where a financial institution actually purchases an enterprise's accounts receivable at a discount that includes interest plus service costs. Factoring combines a credit and transaction product that enables SMEs to better manage cash flow and outsource financial functions. It may be particularly suited to emerging markets where weak legal environments make actual lending contracts less secure. The table below details these and other bank lending technologies identified by researchers in describing a framework for SME lending that extends beyond relationship lending methods.

Lending technologies

Greater likelihood/level of collateral

Technology	Information source	Screening and underwriting policies	Contract structure	Monitoring mechanisms
Small business credit scoring	Hard information (data points) about the enterprise	Based on the SME's score in a statistical model	No collateral required, higher interest rates	Observation of timely repayments
Financial statement lending	Audited financial statements	Based on the strength (and credibility) of the SME's financial ratios	Contracts may vary but future cash flow is primary source of repayment	Ongoing review of financial statements
Relationship lending	Soft information on the SME, owner, and community, gathered over time	Based primarily on the decision or recommendation of the loan officer	Variety of structures	Continued observation of the enterprise's performance on all dimensions of its banking relationship
Factoring	Value of collateral: accounts receivable	Based on the quality of the enterprise's clients	Factor purchases the accounts receivable outright, thus taking over credit and collections	Lender owns the accounts receivable
Asset-based lending	Value of collateral: accounts receivable or inventory	Based on value of collateral	Primary method of repayment is asset collateral	Problematic, as value of the assets must be regularly updated
Leasing	Value of the asset leased	Based on value of the asset	Lessor purchases asset and rents to borrower, who may often purchase at end of lease	Observation of timely repayments
Fixed-asset lending	Value of collateral: real estate, equipment	Based on the assessed market value of the asset, and coverage ratios measuring the SME's ability to service debt	Collateral (asset) worth over 100 percent of loan, throughout amortization schedule; lien prevents borrower from selling asset	Observation of timely repayments

"A more complete conceptual framework for SME finance"

Even when a new lending technology can increase the size of the accessible market, banks must assess the risks and costs of employing this technology. For example, factoring is an effective solution only if the customers of the SMEs are likely to pay their bills and if the bank itself has the necessary competencies to efficiently conduct collections operations. Similarly, the cost of monitoring the assets used for asset-based lending may make it unprofitable for smaller clients.

Thus, for many banks, effective product design includes appropriate standardization. Banks must balance SME demand for products that "fit" with the cost to provide them. For example, banks often find it cost-effective to offer enterprises under a predetermined size, a fixed set of highly structured, standardized loan products. In addition to limiting the types of loans offered, some banks will standardize lending terms such as maturity, maximum amount, and collateral required as well as interest rates, fees, and commissions. To further reduce the time it takes to deliver these loan products, banks may incorporate a checklist of criteria by which to approve SMEs for these loans.

Standardization enables banks to offer a range of products to SMEs that can be sophisticated in their original design — tailored to different SME growth stages, for example — but inflexible and, therefore, efficient in their application. While banks use less standardization when serving medium enterprises, most report that flexibility remains limited.

Collateral and personal guarantees for SME financing

Private lenders only lend when they think that borrowers will pay them back. Over the years, credit markets have developed two successful lending systems: unsecured lending and secured lending. Unsecured lending relies on the borrower's reputation and the lender's assessment of the borrower's future demand for access to credit. Secured lending relies, in addition, on the lender's ability to seize and sell property to satisfy an unpaid loan. Both systems reflect sound economic logic and both attempt to address the main features of credit markets: adverse selection, moral hazard, asymmetric information and uninsurable risk. As the borrower's needs for credit grows, collateral will better address these problems of the lending market.

Credit risk is the risk of lost revenues and assets from delayed payment or nonpayment of loans or other credit products. It is an important concern in SME banking because unlike larger corporations, SMEs often cannot provide verifiable financial information. As a result of this information asymmetry, most bank loans to SMEs are secured, or in other words, require collateral. Since SMEs often lack the collateral required, this limits the size of the market. Emerging market banks report that over 80 percent of SME loans are secured. As a result, banks that can find other ways to manage credit risk without requiring collateral have a potential competitive advantage when serving SMEs.

The use of collateral is a common feature of credit contracts between firms and lenders. The question why the use of collateral is so widespread has been the subject of several theoretical contributions. As mentioned earlier, the contractual relationship between borrowers and lenders may be hampered by the presence of asymmetric information, adverse selection and moral hazard, usually leading to credit rationing. As such, the risk of lending may be reduced by collateral. Collateral may play the role of a signaling device for borrower quality and may lower the agency costs of debt by preventing the problem of asset substitution. In general, when moral hazard risk shows up in the lending relationship, collateral may play a disciplinary role in the behavior of the borrower. Consequently, stronger creditor protection from collateral would lead to better credit terms or even the approval of credit that otherwise would not be granted. Secured credit limits the firms' ability to obtain future loans from other lenders or reduces the risk of excessive future borrowing.

Some people might criticize the unrestricted reliance on collateral and argue that this might have a negative impact on credit-market efficiency. They argue that banks are in a good position to evaluate

the future prospects of new investment projects. Collateral will weaken the bank's incentives to do so. Especially for small firms, banks would do little screening and rely excessively on collateral. From the point of view of banks, collateral and screening can be considered as substitutes. Despite the considerable amount of effort that has been devoted in the theoretical literature to the role of collateral in business lending, only few theoretical studies make the explicit distinction between personal and business collateral. It is believed that personal collateral is more effective in limiting the borrower's risk preference incentives by enhancing the likelihood that the principal will feel any losses personally.

The empirical literature concerning the determinants of collateral is rather scant, partly due to data limitations. While it is well documented that small and medium-sized firms rely primarily on financial intermediaries as lenders, especially commercial banks , only partial clues exist as to the role of personal wealth or business wealth in the contractual details of lending arrangements. To date, as far as we are aware of, only two empirical studies (Ang et al., 1995; Avery et al., 1998) examine the topic. Both studies found that personal commitments are an important component of SME lending. However, no efforts have been made to refine such results by distinguishing the factors related to both personal commitments and business collateral usage. Moreover, no European empirical evidence is available to date.
The 'implicit value' of personal commitments as a disciplining device that limits the borrower's risk preference incentives is higher than for business collateral. The lender receives explicit claims on personal assets and/or future wealth of the borrower, which he cannot rely on in the case of business collateral. Moreover, the likelihood that the borrower will feel any losses personally is higher when granting personal collateral.

The determinants of business collateral and personal commitments

Firm characteristics

A first firm characteristic that could have an influence on the use of personal commitments is the difference between family and non-family firms. Agency models predict that agency costs emerge with fractional ownership, a situation less frequent found in family firms. Family members, having a non-diversified portfolio of investment, are motivated and mainly concerned with the long-term survival of the firm. This induces a reduction in firm risk and volatility of cash flow in order to prevent default. Consequently, the interests of creditors (e.g. banks) are aligned with those of the shareholders. Linking this argument to the credit acquisition process, it is expected that banks will be more cautious

(higher collateral requirements) when dealing with family firms. Furthermore, from the point of view of the firm, personal commitments could bring about potential agency problems between individual partners in SMEs, due to unequal risk sharing among the partners. When some or all partners pledge personal collateral or guarantees, the actions of one partner can place the wealth and personal assets of all other partners at risk. Although this problem may be prevalent in both non-family and family firms, it is expected that because of stronger social bonds in the latter, family firms are less opposed to personal commitments than non-family firms.

Trade credit could be used as a signaling instrument, mitigating the adverse selection problem. Trade credit can play an important role in the credit decision process of banks when suppliers have private information about their customers. Providing trade credit is a credible way for suppliers to convey their private information about the firm to the bank. Thus, when the signaling effect of trade credit is strong enough, the risk of lending decreases and the likelihood that firms have to offer collateral/commitment protection is reduced.

Relationship characteristics

Relationship banking stresses the fact that banks can improve their revenues by maximizing the profitability of the actual relationship with the firm throughout time. So far, research on relationship lending mainly concerns the effect of a strong relationship on the interest rate and credit acquisition. Links between relationship strength and collateral have not received much attention in literature .

A relationship can be defined in numerous ways. The most common measure is the duration of the relationship with the bank. Previous scant empirical research focusing on the link with collateral has stressed this duration of the relationship and has discovered that firms with a longer relationship with their bank incur a lower incidence of collateral as predicted by the model of Boot and Thakor (1994). The capacities and the character of the entrepreneur become obvious as the relationship continues. Also the timely repayment of acquired loans contributes to the reliability of the firm. As time expires, the entrepreneur builds up a good reputation and the moral hazard problem will diminish. Because a good reputation is considered a valuable asset, the firm will prefer a low-risk project above a high-risk project, reducing the probability of repayment difficulties and keeping the value of

the reputation asset intact. The statement that the incidence of collateral is lower as the relationship matures, is also consistent with banks producing private information about the borrower quality. Hence, the duration of the relationship is negatively related to the degree of collateral/commitment protection.

An alternative measure for the strength of the relationship used in previous empirical research is the exclusivity of the relationship. If a financial institution operates as the main banker for a firm, the firm mostly communicates with this particular bank. A bank is considered as the main banker if the relationship has a certain depth by means of purchasing other bank products or services. Through continuous interaction between bank and SME (concerning several bank products), the information asymmetry diminishes. Obviously, this intense communication between both parties creates a mutual trust and reduces the banks' risk involved in granting credit.

Additionally, the number of banks a firm negotiates with before agreeing to a certain credit, may influence the relationship bank-SME. Working with just one bank creates the risk for the SME that this certain bank will abuse the power it has. The relationship between bank and SME creates internal information for the bank. This particular banker of the SME then has an information monopoly compared to other banks and may build up certain market power. Changing banks becomes difficult for the SME since revealing its qualities in a credible way to another bank may take a lot of effort. Thus, the firm becomes 'locked in' in the relationship with the bank.

Loan Characteristics

The time to maturity or loan duration has an impact on the incidence of secured debt: long-term bank debt would be more often secured due to several reasons. First of all, long-term loans require a long-term judgment of the creditor on the creditworthiness of the debtor. A company that is creditworthy at the moment of a credit decision cannot assure that it will remain creditworthy in the future. The chance of occurrence of an adverse event becomes larger when the duration of the loan is enlarged. In this case, collateral has the power to decrease the loan assessment of risk. The pledging of collateral is an effective mechanism for the creditor to ascertain himself of a certain value in the future: a company may not retain its value on a longer term but collateral does most likely retain its value.

Second, the problem of asset substitution is particularly present when providing long-term debt. The term of the loan gives the debtor enough opportunities to alter the projects in subtle ways or even switch from low-risk to high-risk projects. As loan duration falls, the reputation effect becomes much more important.

Third, for firms, which have acquired short-term debt and would actually engage in asset substitution, the wealth transfer would be relatively small compared to the reputation cost (higher future interest rates). Moreover, the speed required to substitute assets would raise costs for the debtor. Consequently, short-term loans will rely less on collateral provision.

From both a theoretical and empirical point of view, loan size would have a positive impact on the provision of collateral by a firm. The advantages of loans backed by collateral (e.g. preventing asset substitution, claim dilution, reducing foreclosure costs), have to be more extensive than the costs that are mainly fixed. For small loans, these benefits cited may not cover the fixed costs including monitoring costs, costs for asset appraisals and administrative expenses. Given these arguments, Jackson and Kronman (1979) conclude that larger loans should be more frequently secured. Thus, the size of a loan is positively related to the degree of collateral/commitment protection.

Lender Characteristics

The screening effort - the time and effort a bank invests in screening the firm demanding for bank debt - could have an influence on the pledging of collateral. In case of SME lending, banks usually have superior expertise in judging the different aspects of project quality in comparison to the often-unrealistic optimistic entrepreneur. Although the disciplining role of collateral to prevent moral hazard by borrowers is well described in literature, collateral also has a potential drawback. Collateral protection may induce banks to be ‘lazy’ and reduce their screening efforts below socially efficient screening levels. Especially for SMEs, it seems that banks do little screening and particularly rely on collateral or commitments demanded. Hence, collateral and screening could be considered as substitutes.

Following are some of the collateral related prudential regulations outlined by SBP:

REGULATION R-2 PERSONAL GUARANTEES

All facilities, except those secured against liquid assets, extended to SMEs shall be backed by the personal guarantees of the owners of the SMEs. In case of limited companies, guarantees of all directors other than nominee directors shall be obtained.

REGULATION R-3 LIMIT ON CLEAN FACILITIES

In order to encourage cash flow based lending, banks/DFIs are allowed to take clean exposure, i.e., facilities secured solely against personal guarantees, on a SME up to Rs 3 million provided that funded exposure should not exceed Rs 2 million. Before taking clean exposure, banks/DFIs shall obtain a declaration from the SME that it has not availed clean facilities from any other bank/DFI to ensure that the accumulated clean exposure of banks/DFIs on a SME does not exceed the prescribed limit mentioned above. It may be noted that the clean exposure above to an SME entity, will not include the clean consumer financing limits (Credit Card and Personal Loans etc.), allowed to the sponsors of the said SME under Prudential Regulations for Consumer Financing.

REGULATION R-4 SECURITIES

Subject to the relaxation in Regulation R-3, for facilities up to Rs 3 million, all facilities over and above this limit shall be appropriately secured as per satisfaction of the banks/DFIs.

Proxy techniques

Effective credit analysis for SMEs requires that credit officers and underwriters focus on the fundamentals of financial performance and apply proven creative methods in acquiring the relevant information to opine on credit-worthiness, to structure / document facilities, and to employ appropriate risk-weighted pricing methodologies, as well as to put in place performance tracking and reporting metrics. The table below lays out some of the challenges to adequate credit analysis for SMEs and proposed solutions.

To prudently assess the credit risk of SMEs in a cost-efficient manner, the analysis should focus on performance or risk indicators that have proven to be useful, in other markets and over time, within specific industries as reliable discriminators for predicting satisfactory credit behavior and risk ranking. They must aid in facility structuring and risk-based pricing. They should include:

- **Use of proxy financial measures and industries norms:** The paucity of reliable financial statements and lack of transparency characteristic of SMEs necessitates the use of proxy / surrogate financial measures and industry norms. While not a substitute for analysis of the borrower's financial performance, the use of such proxy measures have proven to be a practical and reasonably reliable way of predicting SMEs' financial performance, in many emerging markets in the absence of complete or transparent information – such as professionally audited financial reports. Proxy financial measures typically can be developed from the following sources:

  - **Listed companies:** The publicly available financial data (Key Balance Sheet and Income Ratios, Profitability dynamics and Returns) of listed firms can be used as industry bench marks to be compared with SMEs and to help affirm the quality and viability of a particular firm. The business operations of the listed companies used as proxies should be in the same sector and geography as those of the SME borrower.

  - **Accounting firms:** Credit officers can work with reputable accounting firms which have a history of auditing companies within a particular industry or sector to build, validate and annually review key surrogate financial indicators and assumptions.

  - **Industry associations:** Industry associations have in-depth knowledge of the financial conditions of their industry. In many cases, such information is publicly available. The following efforts are also necessary for thorough assessment and prudent lending practices:

    - Analyze the credit history of the SME firm and its principals: Since SMEs often lack credit history and the firm's financials are often intertwined with the principals' personal financial resources, the credit analysis may include both the firm and its principals. The analysis of the principals should be dependent on how much of the firm's income and expenses are reported in the principal's personal accounts. Often a "word picture" of a principal's possible net worth or income needs to be developed through frank

discussions and observations of life style rather than signed and audited personal financial statements.

- Fully understand the purpose of the financing required and the appropriateness of the quantum requested as well as the tenor.

Accounting Ratios for SME financing

Profit and Loss accounts, Balance sheets and Cash Flow Statements are at the heart of business lending. These are the financial base documents that bankers analyze and from which a ratio analysis can be derived in order to establish trends within the business and highlight significant features. Ratios are also useful in comparisons with past results, peer performance, and industry norms. These financial statements and their analysis and comparisons enable in assessing the customer's needs and creditworthiness. The essential question to be answered is: can this business and its management make the interest and loan repayments within the agreed timescale?

Once an advance has been made, strict monitoring and control is required to ensure that the business is performing as planned and that the level of risk stays the same as was originally accepted. Prompt action will be needed to understand any deviation from the budgets agreed at the outset, and the appropriate action taken. It is the cash flowing through the business which generates the profit that increases the net current assets and so builds up the capital, or shareholders' funds, in the balance sheet (unless these profits are drawn out by the proprietors/shareholders). The financial accounts are the "language" of the business in which the results are communicated to the management, owners and those who lend it money, as well as those whom the management chooses to inform. Hence the key importance of the cash flow statement, profit and loss account and balance sheet in financial analysis.

Financial Statements

Following is a sample of a financial statement which is referred to for calculating ratios at the time of lending to an SME.

Newton Ltd
Trading, Profit and Loss Account
for the year ended 31 December 2009

		£	£	£
Turnover				1,530,000
Less	Cost of Sales			
	Stock at 1 Jan 2009	210,000		
Add	Purchases	920,000	1,130,000	
Less	Stock at 31 Dec 2009		252,000	878,000
GROSS PROFIT				652,000
Administration Expenses				
Directors' Remuneration		60,000		
Auditors' Remuneration		8,000		
Salaries and Wages		110,000		
Expenses		66,000		
Motor Vehicle Costs:				
	Admin	16,000		
Depreciation:				
	Motor Vehicles	6,000		
	Machinery	4,000	270,000	
Distribution Expenses				
Salaries		120,000		
Expenses		60,000		
Motor Vehicle costs:				
	Distribution	42,000		
Depreciation:				
	Motor Vehicles	8,000		
	Machinery	6,000	236,000	506,000
				146,000
Other Operating Income				
Rent Receivable				24,000
				170,000
Interest Payable				
Loans repayable within 5 years			1,000	
Loans repayable after 5 years			3,000	4,000
Profit on Ordinary Activities before Tax				166,000
Taxation				50,000
Profit on Ordinary Activities after tax				116,000
Unappropriated profit b/f				110,000
				226,000
Ordinary Dividend			60,000	
Unappropriated profit c/f				£166,000

This account is produced for the company's own uses. The main object of a trading account is to calculate the gross profit.

Sales is the turnover, or revenue (the total value of goods sold) by the business.

Cost of Sales = Opening Stock plus Purchases, less Closing Stock

Gross profit is the profit the business has made on buying and then selling goods, i.e. on trading.

Gross profit = Sales less Cost of Sales

Administration expenses cover the day-to-day running expenses of the business such as heating, lighting, rent, wages and salaries, and depreciation.

Distribution expenses are costs incurred in either selling the goods or transporting them to the customer, for example, salespersons' salaries and expenses, advertising costs,etc.

Ratio Analysis

Given any two figures you can make a ratio out of them. However, we need to focus on calculating ratios that are both meaningful and add value to the overall analysis. While the results of ratio calculations will provide isolated indicators on the business's performance, the real value is in a comparison with previous figures and thus being able to complete a trend analysis. This helps to find the reasons for movement or variance from historical performance or what was forecasted. Ratio analysis facilitates determining whether the performance of the business is improving or deteriorating, and this will influence the bank's decision on lending to the SME.

Types of ratios

We shall calculate and examine ratios under the following headings:

- Financial ratios based on the capital structure of the business and its liquidity ratios
- Profitability ratios
- Operating and activity ratios for the business

Financial ratios: capital structure and liquidity ratios

Financial ratios are designed to show both the long term and the short-term financial position of a business. The main ratios are for capital adequacy and working capital or the current ratio (as it is also known). If either of these ratios produces an unsatisfactory result, it may be necessary to produce further ratios to delve more deeply.

$$\textbf{Capital adequacy ratio} = \frac{\textbf{Proprietors' funds less intangibles}}{\textbf{Total assets less intangibles}} \times \frac{100}{1}$$

Intangibles are those assets in the balance sheet which only have a value if the business can be sold as a going concern. Goodwill is an example. As a prudent assessment of risk, therefore, it is better to exclude such items from calculations. If the firm fails, there is no goodwill.
Proprietors' funds are usually called "Capital & Reserves" or "Shareholders' Funds" or "Shareholders' Equity" in the balance sheet.

The capital adequacy ratio is calculated to show how much money the owners have in the business. Although there is no one percentage figure which suits all businesses, the higher this figure, the more protection there is for lenders, should things go wrong.
The capital and reserves in the balance sheet is the safety buffer for the creditors of a business. The capital will have to be totally lost before any creditors, including the bank, lose money. As a general rule, the bank may not want to lend more than the proprietors have in the business (it will not want to have a greater stake in the business than the owners).

Example

Given the following summarised balance sheet:

Fixed assets	300,000
Current assets	500,000
Total assets	800,000
Capital & Reserves	300,000
Long term liabilities	100,000
Current liabilities	400,000
Total liabilities	800,000

So long as the total assets realise at least £500,000 (62.5% of their book value) the creditors (long term liabilities and current liabilities) will be paid in full.

Case study

W Smith PLC

The directors of W Smith plc, manufacturers of knitting wools are due to meet you to discuss their financial requirements for the coming year. The following figures have been extracted from their accounts for the last three years.

Balance Sheet

	20X1	20X2	20X3
	£000s	£000s	£000s
Fixed (or Non-current) assets			
Goodwill	85	65	45
Premises	625	625	625
Plant	530	615	700
Total Fixed Assets	**1,240**	**1,305**	**1,370**
Current assets			
Stock (or Inventories)	330	360	380
Debtors (or Receivables)	375	405	420
Cash	-	-	-
Total Current Assets	**705**	**765**	**800**
Total Assets	**1,945**	**2,070**	**2,170**
Current Liabilities			
Bank borrowing (or Borrowings)	50	50	50
Creditors (or Payables)	60	100	140
Current tax payable	150	185	210
Proposed dividend (Provisions)	60	70	85
Total Current Liabilities	**320**	**405**	**485**
Creditors: amounts falling due after more than one year (or Non-Current Liabilities)			
Borrowings:			
7% Debentures	200	200	200
10% Unsecured Loan Stock	400	400	400
Bank Term Loan	350	350	350
Total Non-Current Liabilities	**950**	**950**	**950**
Total Liabilities	**1,270**	**1,355**	**1,435**
Net Assets	**675**	**715**	**735**
Shareholders' Equity (or Shareholders' Funds, or Capital & Reserves)			
Share capital	375	375	375
Reserves (or Retained earnings)	300	340	360
Total Equity	**675**	**715**	**735**

Profit and Loss Account (or Income Statement)

	20X1	20X2	20X3
	£000s	£000s	£000s
Sales	1,800	2,160	2,520
Net purchases (or Cost of Sales) (1)	720	920	1,150
Gross Profit	1,080	1,240	1,370
Distribution costs & administration expenses	540	610	650
Operating Profit	540	630	720
Interest payable	180	200	270
Profit before tax	360	430	450
Tax [Not given in this example]			
Profit after tax			
Dividends [not given in this example]			
Retained profit			

Note (1): Cost of Sales = Opening Stock plus Purchases, less Closing Stock

Capital adequacy

To calculate the capital adequacy ratios for W Smith plc, we take the balance sheet figures for Shareholder Equity (also called Proprietors' Funds, or Capital & Reserves) and deduct goodwill, which is also deducted from the total assets denominator of the calculation.
Thus, taking Year 20X1, Proprietors' funds = Capital & Reserves (£675,000) less Goodwill (£85,000) = £590,000. Likewise, Total assets less Goodwill = £1,945,000 less goodwill = £1,860,000.

$$\frac{\mathbf{590,000}}{\mathbf{1,860,000}} \quad \mathbf{x} \quad \frac{\mathbf{100}}{\mathbf{1}} \quad \mathbf{= 31.72\%}$$

Ideally you are looking for a figure in excess of 50%, but this is not always possible, and where the figure is below 50%, it is essential to calculate:

Gearing ratio

This is calculated as follows:

$$\frac{\textbf{Proprietors' stake}}{\textbf{Medium and long term borrowings including preference shares}}$$

The gearing is fundamentally the relationship between debt and capital. Debt in a balance sheet has to be repaid; capital does not, it is permanent.

It is important to remember that a business which is highly geared has to maintain its profits in order to ensure that it can meet its commitments to its outside lenders. Interest is a fixed cost which needs to be met despite any drop that may occur in sales and thus the profit available to meet the interest payments. Any problems with profit forecasts should be regarded as being potentially serious and may affect your decision to lend. We like to see the proprietors' stake in the business, also called Capital & Reserves or Shareholders' Funds, at least covering the medium and long term borrowings including preference shares. Thus you should be looking for a 1:1 ratio at least, if not 1+: 1.

Some banks also calculate this ratio using total debt, instead of medium and long-term borrowings.

Interest cover ratio

This is calculated as follows:

$$\frac{\textbf{Net profit before interest and tax}}{\textbf{Interest paid}}$$

This shows the number of times the interest payments can be met out of current profits. Again, any changes to this ratio should be investigated before loan agreements are renewed. A deterioration in this ratio means the business has a reducing capacity to meet the interest it has to pay. The trigger for a debt crisis within a business is often an inability to make interest payments when due. While cash flow is a critical factor, an early warning of problems can be determined from the interest cover ratio which measures the ability of the company to meet its interest obligations. Preference shares are usually included in this ratio as they receive an interest payment, and it may be appropriate to include any other borrowings where interest is payable, including short term borrowing where this has come from a source other than the bank.

Liquidity

Liquidity means the availability of cash to meet the needs of the business. This involves managing the firm's trading cycle through the conversion of sales to the collection of cash for those sales. Liquidity covers the prudent management of the flow of funds through the business. One analogy is to say that if the wheels of business are oiled by cash flow, then the cash budget gauges how much oil is left in the can at any time. In any lending situation, it is very useful to understand the importance of liquidity and how it is controlled.

A key measure of liquidity is the:

$$\textbf{Working capital ratio or current ratio} = \frac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$$

This ratio tells us how much current asset cover there is for each PKR1 of liabilities. It gives an indication of the ability of a business to pay its short term debts (the creditors, bank overdraft, etc) as they fall due without having to resort to selling any fixed assets. However, this is not a ratio which you should view in isolation. Included within the ratio, in the current assets, could be a great deal of stock and so you might want to check how the stock was valued at the year end. One way round this is to look at how this ratio changes over a period of years. If the pattern is consistent and stock is valued on the same basis each year, there is unlikely to be anything untoward; the trend is more important than one year's ratio as it highlights the need to further investigate variances in performance.

Even if the bank is happy with the current ratio (and in W Smith's case it is falling), it is prudent to take the examination of liquidity a stage further and calculate another ratio that strips out the stock. This ratio is known by several names: the liquid ratio, the quick ratio, the liquid asset ratio, or the acid test ratio. This ratio may reveal that an apparently comfortable current ratio is misleading in terms of extinguishing current liabilities because of the high proportion of stock in the current assets. Stock is the current asset least easily turned into cash – the least liquid current asset.

$$\textbf{Liquid ratio (or quick ratio/liquid asset ratio/acid test ratio)} = \frac{\textbf{Current Assets excluding Stock}}{\textbf{Current Liabilities}}$$

Stock will of course include the figures for raw materials, work-in-progress and finished goods which are sometimes shown separately in the balance sheet.The usefulness of this ratio may

depend on the proportion of stock in the current assets. It is worth restating the importance of trend analysis and also how to interpret the results. A current ratio of 2.0 may look satisfactory but we need to consider the industry norm within that sector, that is, consider the figure for the business against its peer group in the same industry.

Profitability ratios

When examining the profitability of the business there are three ratios to consider:

Gross profit ratio

$$\frac{\textbf{Gross Profit}}{\textbf{Sales}} \quad \textbf{x} \quad \frac{\textbf{100}}{\textbf{1}}$$

This is the most basic measure of profitability. It measures the relationship between gross profit (sales less the cost of making these sales) to sales. It is a very important measure of profitability because it tells us whether the business is making a profit on its main area of activity – the buying and selling of product.
It is not easy for a business to significantly increase this gross profit margin and a declining margin would be a concern.

Net profit ratio

$$\frac{\textbf{Net Profit}}{\textbf{Sales}} \quad \textbf{x} \quad \frac{\textbf{100}}{\textbf{1}}$$

Net profit on trading is also an important measure of efficiency.

Return on capital employed

$$\frac{\textbf{Net profit}}{\textbf{Owners' stake}} \quad \textbf{x} \quad \frac{\textbf{100}}{\textbf{1}}$$

Owner's stake is synonymous with Capital & Reserves. With the Return on Capital Employed (ROCE) ratio, it is important to assess the total capital of the business including any long term loans put into the business by the owners and to deduct from this figure the intangible assets such as goodwill. If this is not done, we may get a very high return on owners' capital which would not be a true reflection of the actual return. There are several methods of calculating ROCE but the one given above is consistent with the approach being used in all the examples.

We now turn to the operating and activity ratios which measure how efficiently a business is being run – how well it has used its resources.

Operating/activity ratios

For the most part, the method of calculating these ratios is:

$$\frac{\textbf{Operating expenses}}{\textbf{Sales}} \times \frac{\textbf{100}}{\textbf{1}}$$

Operating expenses are equal to all fixed costs. Sales, net of returns, are used as most of the business's expenses can be related to sales. Perhaps the best example from any set of accounts would be cost of materials related to sales. One would expect material costs to rise in proportion to any increase in sales. If the computed figure is lower on increased sales, this would imply that the business was getting the benefits of increased size. If material costs rise faster than sales, an explanation should be sought.

It is not always possible to obtain figures for all the fixed costs of the business. In these circumstances, the ratios used can be the expenses to sales. For example, add together the Distribution Costs and the Administration Expenses shown in the Income Statement (Profit & Loss Account) and express them as a percentage of Sales. These two costs can also be expressed as a percentage of sales individually.

Breakeven ratio

A breakeven analysis is significant in that it enables the bank to identify the sales volume necessary to cover all costs of the business and start to make a profit. When the profit contribution matches the total fixed costs, the business has reached its breakeven point, thereafter it is making profits. The figure is calculated:

$$\frac{\textbf{Fixed costs}}{\textbf{Gross margin \%}}$$

Before completing this calculation, the fixed costs and gross margin figures need to be examined to find out what has been included. The results can be distorted if certain figures have been wrongly designated. For example, in an industry such as clothing manufacture where there is a high level of piecework (work paid for according to the quantity produced) this should be included in the calculation of the gross margin but can often be added to employees' wages which are a fixed cost. You may be left with little alternative but to make an estimate, particularly when dealing with a sales force who earn a basic salary (fixed cost) plus a bonus or commission based on volume sales (gross margin). To produce as robust and meaningful a figure as possible from this calculation,

you must try to identify all costs which relate directly to production. Gross Margin is Gross Profit divided by Sales and expressed as a percentage.
Although these two operating ratios are important, there are important activity ratios which are not based on an operating expense. The most important as far as a lending organization is concerned are stock turnover, credit allowed (debtors ratio) and credit received (creditors ratio).

Stock turnover ratio

$$\frac{\textbf{Cost of goods sold}}{\textbf{Average stock}}$$

As a reminder:
Cost of Goods Sold = Opening Stock + Net Purchases – Closing Stock

The best way to calculate average stock if you don't have the figures for the cost of goods sold and purchases is:

$$\frac{\textbf{Opening stock + Closing stock}}{\textbf{2}}$$

This calculates the number of times stock turns over. To calculate the number of days' stock on hand, divide stock by the cost of goods sold and multiply by 365.
As long as there has been no change to the accounting policies for stockholding, then the figure should be consistent from one year to the next, allowing the bank to make some comments on the efficiency of the business. An increased stock turnover figure shows stock is being turned over more quickly and indicates greater efficiency.

Generally, an increasing stock turnover shows that sales are rising which should be reflected in increased profits, but it could also be caused by a change in stockholding policy. For example, if a firm in the past always held two months' stock in hand, we would expect to find a stock turnover for the year of approximately 6. Change the stockholding to one month and stock turnover rises to 12. Such a decision would be beneficial to the firm in one major respect – less money tied up in stocks would lower costs and increase liquidity.

This would have to be balanced against the risk of running out of stock more frequently which could result in loss of sales greater than the cost savings made by reducing stock levels.

The debtors and creditors ratios

These two ratios go together. In the first, we are looking at how long a period of credit is given to customers of the business (its debtors). In the second, we are looking to see how much time is given to the business by its suppliers (creditors) before their bills need to be paid. Ideally, both ratios should work out at the same figure, but very often this is not the case. The formula for calculating each is similar:

$$\frac{\textbf{Debtors}}{\textbf{Credit sales}} \times \frac{\textbf{365}}{\textbf{1}} \qquad \times \qquad \frac{\textbf{Creditors}}{\textbf{Credit purchases}} \quad \frac{\textbf{365}}{\textbf{1}}$$

If sales are not split into credit and cash sales, then the credit sales figure is not given separately. In these circumstances, it is common to use the total sales figure, if possible applying your knowledge or research of the type of business you are dealing with to make some assessment of the likely amount dealt with on credit. In the case of purchases (in the creditors ratio), it is common to use the cost of goods sold or the total purchases figure in the calculation.

These two ratios are quite easy to calculate, and they can tell you a lot about the way the SME business is being operated. By looking at changes in the debtors ratio, you can be put on your guard if a sudden increase in the ratio takes place. The explanation might be simple – increased sales may all have been credit sales rather than some for credit and some for cash. This would obviously push the ratio up, but equally so would a situation where the business is not keeping up to date with the invoicing and collecting payment from customers. This might provoke you, the banker, to ask questions about its credit control procedures and indeed the possibility that some of the debtors may be bad debts.

In fact, along with the accounts, you should often ask for an up-to-date debtors' analysis sheet which will immediately highlight any debtors which are outstanding for a long period – say, three months or more, which could become bad debts.

A decrease in the time granted for credit could be a simple matter of more cash sales or better credit control, or the owner might be pressing customers to pay more quickly. Such a policy might lead to decreased sales in the future.

Changes in the creditors ratio might have a simple explanation. Debtors paying more quickly may be allowing the business to pay

its creditors more quickly, or the business may not have been taking the full credit period to which it was entitled. It could also imply, however, that the business has cash flow problems and cannot pay creditors as quickly as in the past.

Changes in these ratios should be investigated either by looking more closely at the accounts or through discussion with the SME client.

Key Financial Performance Metrics

Profit and Profitability	• **Profit Margin** Net Income/Annual Sales • **Return on Assets: ROA** Net Income/Average Total Assets • **Return on Equity: ROE** Net Income/Average Total Equity • **Income recognition principles** Credit payments assessed as income
Firm Efficiency	• **Asset Turnover** Total Sales /Average Total Assets • **Inventory Turnover** Cost of Goods Sold (COGS)/Average Inventory Number of Days in Period/Inventory Turnover • **Receivable Turnover** Net Credit Sales /Average Receivable Number of Days in Period/Receivable Turnover
Working Capital	• **Current** Current Assets /Current Liabilities • **Quick Asset** Quick Assets /Current Liabilities • **Working Capital** Net Working Capital/Total Assets
Debt Service - Liquidity and Leverage	• **Interest Coverage** Net Income Before interest and Taxes/Interest Expenses • **Debt Coverage** Net Income Before Debt Services and Taxes/ Total Debt Repayment • **Account Receivable Turnover** Net Credit Sales /Average Receivables • **Asset Turnover** Sales/Average Total Assets • **Debt Equity** Total Debt/ Total Equity
Borrowing Needs	• **Cash Conversion Cycle** Days Inventory Outstanding (DIO) plus Days Sales (Receivable) Outstanding (DRO) minus Days Payable Outstanding (DPO) DIO + DRO - DPO = CCC
Market Position	• **Firm Position (quartiles)** Financial Performance and Size

Cash flow reporting

We have already identified the importance of cash flow and of ratio analysis. We now take this a stage further by looking at the cash flow report.

In addition to quantitative analysis, credit officers should conduct qualitative analysis of the SME borrower to rate its credit, performance and market risks. Qualitative analysis is fundamentally important because it identifies the key risks in the industry where the borrower operates and provides a tangible method to rate and rank borrower performance within the industry. Similar to quantitative analysis, effective qualitative analysis requires the development of key metrics that represent the credit, performance and market risks of the specific industry and region of the borrower. Qualitative risk metrics should focus on the key indicators that logically align with the SMEs' industry sector and business model and be based on practical and accessible information. In order to provide an accurate picture of the borrowers' credit and performance risks, the qualitative metrics should be used as a comprehensive framework and be explicitly linked to the borrowers' financial conditions and the quantitative analysis. The key qualitative metrics must be customized for the SME's industry and should include the following key metrics:

- Cash Flows
- Payment Risks
- Operational Costs
- Market Position and Risks

Cash Flows	▪ Operational capacity - plant online operational rate ▪ Access to suppliers and input ▪ Quality of upstream suppliers ▪ Payment source for Suppliers ▪ Payment by cash/credit ▪ Accounts payable turnover ▪ Employee salaries ▪ Profile of customers - Government, SOES, private firms (listed or SMEs) ▪ Payment method from customers
Payment Risks	▪ Financing situation of the borrower - self financed/credit ▪ Contract enforcement factors - appointment terms of the contract signatory ▪ Shareholders of the borrower - Government, SOEs or private enterprises, SMEs, individuals
Operational Costs	▪ Management quality of the plant facility - quality and age of the current installed equipment

Market Risks and Position	▪ Factors that determine first, second, and third tier firms - product quality market and customer segment ▪ Past performance during previous economic/industry slowdown response from suppliers/customers ▪ Borrower's management of key industry bottlenecks and ▪ feedstock shortages

One of the key areas that banks always focus on is the ability of customers to repay their borrowings. There is little point in granting credit to someone who is unable to pay it back because it places them under excessive financial strain. We have already identified that having to rely totally on security pledged as a primary source of repayment is never a good principle of lending. Cash is the lifeblood of the business. Without cash, a business cannot pay its bills, wages and taxes, nor buy goods and services from suppliers, nor purchase assets, and still have enough liquid resources to meet unexpected demands for money. Any interruption in the flow of cash through the business can be like a blood clot, potentially very dangerous.

It is important at this point to make the distinction between cash flow and accounting profits. Cash flow is the simplest possible concept: it is the difference between money received and money paid out. In order to obtain accounting income, however, the figures are adjusted in two important ways:

- to show income and profit as it is earned (at the time of sale) rather than when the cash is actually received; a company's debtors will usually pay the company after an agreed period of credit – say two or three months

- to categorize cash outflows into current expenses and capital expenses.

A business must be able to turn profits into cash. Assessing the ability of a business customer to repay loans is fundamentally not very different from assessing your own personal ability to borrow – you assess the adequacy of your income against the amount of your expenditure. The one major difference is the earnings of a business require to be adjusted back to cash basis because of what is called "accrual accounting", as we saw above.

You will have an income and you will spend this on rent, loans, mortgage payments, telephone, electricity, etc. You receive a cash income each month and make cash payments each month by direct debit or card transactions. If you have a surplus you may open a

savings account; if you have a deficit then you will borrow either on overdraft or credit card.

A business customer has income, but it is derived from sales which are reduced by the cost of sales and fixed costs to give a profit. Businesses, however, have balances to be collected from trade debtors, stock to be held for future sales and trade creditors wishing to be paid when these are due.

CREDIT SCORING AS A TOOL FOR SME FINANCING

There are several different lending technologies available to lending institutions to assess the creditworthiness of their borrowers. These different lending technologies can generally be grouped into two types: transaction lending and relationship lending. The main difference between the two is that the former technologies are primarily based on 'hard' quantitative data or data that can be easily quantified (e.g., financial statements, bank account details, credit scores etc.) whilst relationship lending is based on 'soft' qualitative data or data that can be observed through time but not easily quantified (e.g., track record, management capability, market share, banking relationship etc).

The different types of transaction technologies include financial statement lending, credit scoring, asset-based lending, factoring and trade credit. These various types of lending technologies can be distinguished by the type and source of hard information that is the main basis for the underwriting decision. Briefly, financial statement lending involves underwriting loans based on the strength of the borrower's financial statements. Credit scoring is based on hard information about the firm and its owner, which is usually derived externally, often from credit bureaus. Asset based lending is an extension of credit based primarily on the value of the assets pledged as collateral rather than the underlying creditworthiness of the borrower. Factoring is a narrow form of asset based lending where the lender purchases the borrower's accounts receivables. Trade credit lending involves financing of an underlying trade transaction between the borrower and its suppliers or customers.

As discussed above, credit scoring is actually one of several different lending technologies available to lending institutions to assess the creditworthiness of their borrowers. In actual practice, financial institutions deploy a combination of technologies in loan evaluation. For example, a credit score may make use of information consisting of both the borrower characteristics and its financial statements or the credit score is used in conjunction with relationship or asset based lending.

From survey observations, many bank respondents in ASEAN apply the term ‘credit scoring’ more liberally than its actual definition. They generally understand credit scoring as any methodology that involves risk ranking or grading of the borrower based on factors that may or may not include hard or objective information about the firm and its owner but which would still eventually distil into a single grade or ‘score’. Whether this process of ‘scoring’ is manual or automated is secondary for most respondents. Of greater relevance is the interest and capability of financial institutions to undertake a consistent, objective and systematic risk assessment of SME that is based on the general precepts of credit scoring.

Before a bank can be in a position to agree to lend money to a customer, it must have a certain amount of information about the customer so as to estimate their likely ability to repay the loan. Credit scoring can be used, therefore, as part of a standardized approach to determining creditworthiness.

Credit scoring is the set of decision models and their underlying techniques that aid lenders in granting credit by assessing the risk or creditworthiness of borrowers. Small business credit scoring is based on hard information about the SME and its owner. The information on the owner is primarily personal consumer data (e.g., personal income, financial assets, home ownership) obtained usually from consumer credit bureaus and/or other data gathered from bank records. The data is entered into a loan performance prediction model to yield a score for the loan. Based on the score, the bank makes a decision (in some cases, this process is automated) to approve or reject the loan. The process determines the statistical probability that the credit will be repaid. There is no universal system of credit scoring; nor is any system perfect.

Credit scoring is most often used in retail banking units where they are primarily dealing with personal customers. However, the smaller end of the Small and Medium Enterprise Businesses (SMEs) sector can have credit risk assessed using the same techniques as for consumers. Credit scoring is an ethical decision-making process and, if applied correctly, it should reduce the number of instances where customers borrow more than they can afford.

As well as assessing credit risks, a form of credit scoring is used to determine the suitability of the various accounts that could be offered to a customer wishing to open an account that has “automatic” credit facilities. Credit scoring is used extensively for

mortgages, credit cards and other types of revolving credit.

Credit scoring is one of the most accurate, consistent and fair forms of credit assessment. It uses information provided on an application form, external data from credit reference agencies (CRAs) and applies internal statistical information on the credit histories of applicants who have previously repaid (or not) their credit on time.

Practice of Credit Scoring for Small Businesses

Credit scoring for consumer loans started in the 1950s but extended to small businesses only in the mid 1990s in the U.S. The main type of information used in small business scorecards is the personal credit history of the owners. As such, credit scoring may be applied to informationally opaque SME given that much of the score is determined by the personal history of the owner not the SME. However, in countries where consumer credit bureaus are not available or where information is insufficient, inclusion of other hard information such as the firm's business and financial statements have been featured in many risk scorecards developed by financial institutions. The practice of credit scoring for SME appears to be associated with an increase in lending to opaque SME. Research also suggests that large banks adopted this technology earlier than small banks.

Pre-requisites of Credit Scoring

The pre-requisites to develop a credible credit scoring model for SME are as follows:

(i) A sufficiently sizable sample of previous borrowers and their repayment history.

  a) Sample must be representative of SME who are likely to become borrowers in the future

  b) Sample should contain sufficiently adequate portion of 'good' and 'bad' outcomes to make it possible to identify characteristics that reflect these outcomes.

(ii) Information on borrower (e.g. age, residential status, education, income) for application scoring and transaction data (average account balances, value of transactions, repayment patterns). In the case of SME, one could also consider the financial statements of the firm which are usually distilled into financial ratios for analysis.

Process and Methodologies for Building Scorecards

Credit scoring systems are based on the past performance of borrowers who are similar to those who will be assessed under the system. The aim of a credit scoring system is to predict risk. This is usually done by taking a sample of past borrowers with their application details and subsequent performance history and trying to identify the connections or common predictors that differentiates a 'good' from a 'bad' borrower. This process leads to a scorecard where the main differentiating characteristics or predictors are given scores, which will aggregate into a total score to indicate the risk of a borrower going bad. There are two main types of scorecards, application scorecards, developed using only data available at the time of loan application and behavioral scorecards which utilize information gathered from after the borrower becomes a customer of the bank.

Application scoring

In the credit risk arena, a number of different models can be used to predict different outcomes. For example, a credit scoring model may be built to:

- predict the likelihood of a new loan account going "bad" or becoming delinquent
- determine the amount of credit limit to be allocated to a new credit card
- predict the credit risk of approving a new current account and providing overdraft facilities.

These types of credit scoring are generally referred to as application scoring. Application scoring is used for new and existing customers and is a single point in time assessment for credit. Typically, an application scorecard will use application data and credit reference bureau data in the decision-making process. If available, behavioral data may also be used.

Behavioral scoring

Additionally, credit scoring can be used to:

- increase a credit card limit for an existing credit card customer
- decide whether to pay or return transactions presented against an existing current account if insufficient funds are available
- upgrade credit or debit cards from standard to gold and beyond.

These types of credit scoring are generally referred to as behavioral scoring. Behavioral scoring, unlike application scoring, is used for existing customers only and is an ongoing, updateable assessment for credit. Typically, a behavioral scorecard will use application data, credit reference bureau data and behavioral data in the decision-making process.

Behavioral scoring was a later development in credit scoring but is a more powerful credit scoring tool than application scoring because we use actual working knowledge of the transactions and activities that are running through an operative account, such as a current account, a credit card account, etc. Additionally, behavioral scores are normally calculated on a regular basis (monthly) and give an up-to-date view of the credit risk of a customer.

Scorecard Development

When a customer wishes to borrow from the bank they generally have to complete an application form which contains a great deal of information and data about the customer. Certain aspects of the data are analyzed by awarding points according to the answers given on the form. Usually, before the bank will agree to lend to the customer, a certain minimum score has to be attained. The systems are normally computer-based.

Credit scoring is a statistical means of assessing the probability of repayment of the loan. This risk assessment technique is neither a crystal ball nor a means of forecasting whether an individually scored credit applicant will repay their debt as promised. What it can do is assess the credit risk of the applicant using the historical repayment record of individuals with similar characteristics in their financial profile. The bank uses its historical credit experience to estimate the degree of risk – low, moderate or high. For example, the statistics may show that the customer, when compared with similarly classed customers, behaved satisfactorily at a rate of say 30: 1.

In estimating the probability of non-repayment (default) in this way, those who pass the score set by the bank are regarded as an acceptable default risk, and applications for credit where the score falls below the accepted score are rejected. Normally those with a low number value score are rejected. An application with a high number score (and above the acceptable score) is agreed.

The term "scorecard" is often mentioned when credit scoring is discussed. This refers to the set of points used in scoring an

application. Points are allocated according to the characteristics of various applicants whose accounts:

- were fully repaid on time with no issues
- are then compared with the characteristics of those facilities that were either slow to repay (required intervention of some kind) and
- are compared again, this time with those who did not repay their loan in full.

For example, what you may discover is that applicants who had cheques or direct debits dishonored in the last 12 months are more likely to default on loans x% more than a customer who did not have debits returned unpaid.

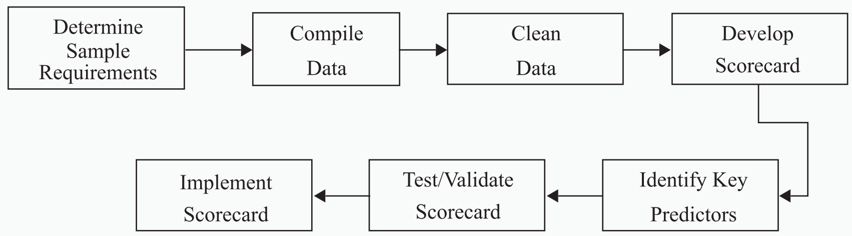
Points are assigned to each characteristic that reflects the comparison between good and slow and problem loans. The characteristics used may range from post code to home ownership, length of time at address, to having a land line telephone.

In developing a credit scorecard, the underlying techniques used to identify the common predictors of an outcome range from non-statistical methods such as expert judgement, linear programming, and neural networks to statistical methods such as discriminant analysis, logistic regression and classification trees.

When a scorecard is built, it is by necessity built on historical data. But once developed, the scorecard will be applied to new borrowers (application scorecard) and/or on existing borrowers (behavioral scorecard) whose risk may have changed over time. Validation of the scorecard (at time of development and monitoring on an on-going basis after deployment) is important to ascertain how representative the sample used in the scorecard is to the current profile of borrowers. This can be performed with various tests, which compare the prediction of the scorecard with actual outcome. Once the validation is complete, the cut-off scores to trigger the various loan decisions will have to be made.

The credit scorecard can be implemented at loan application time and/or as a monitoring tool during the life of the loan. New borrower is scored at application and is accepted or rejected based on the credit score and/or other considerations in conjunction with the credit score. Subsequently re-scoring can be conducted at regular intervals to monitor the borrower's risk profile. The process of scorecard development is summarized in the following diagram.

Process of Credit Scorecard Development



Sample Credit Scorecard for SME Borrower

Predictor	Score	Predictor	Score	Predictor	Score
Age		Income		Debt-Income	
18-25	20	<5,000	15	0-10%	30
26-35	25	<15,000	18	11-30%	25
36-43	35	<35,000	26	31-40%	15
44-52	40	<70,000	36	41-60%	10
>53	50	>70,000	55	>61%	5
Score	25		26		25
Total Score	76				
Loan Decision	**Accept**				

Problems Encountered with Rating Systems/Credit Scoring

Banks reported a number of problems and constraints faced when deploying the rating system/credit scorecard for SME. Common issues include the following.

- Lack of historical data on SME for validation and benchmarking
- Reliability, timeliness and frequency of financial information supplied by SME
- Difficulty of quantifying soft factors

The main problem relate to data availability and reliability. Given that SMEs in many countries are not required to have their financial statements audited, verifying the accuracy and reliability of such information can be difficult.

Benefits of credit scoring

- A consistent and impartial assessment of customers – all customers are treated the same and fairly.

- Allows management to control the "credit tap", that is, increase or reduce credit exposures, thus giving the bank control over approval volumes /"bad" rates.

- A uniform method of processing standard customer requests.

- An increase in ability to consider volume credit approvals irrespective of value.

- Much improved management information systems – it is all electronic based.

- An efficient, cost-effective method of credit risk assessment.

- With a standard and tested system, the quality of the credit portfolio will be reliable during a stable economic cycle.

Boundaries of credit scoring solutions

- A sizeable number of historical applicants and repayment patterns data are normally required to build a credit scorecard.

- Can be expensive to build and put in place, although there is a choice between in-house built systems and off-the-shelf purchased systems.

- Is time sensitive – efficiency deteriorates over time. Very old data can prove to be unreliable for making plans for tomorrow, so scoring systems need to be replaced or updated over time.

- Is not infallible and errors can occur.

- Not all lending decisions are suitable for a scoring solution.

- Will not solve all credit issues.

Obviously, a great deal of skill and time needs to go into the preparation of an application scorecard – similarly, with the behavioral scorecard. This is a specialized area of credit risk practice. It may be that these scorecards are produced for the bank by outside suppliers expert in this field.

Monitoring credit scoring

Scorecards are regularly reviewed to ensure that they are still appropriate to the customer base of the financial organization. The review will normally measure the following performance areas:

- Stability of the current score in comparison with the historical performance – has the level of declined applications increased, for example?

- Have there been changes of the makeup of the customer base?

  How effective has the override performance been (where the lender has not followed the course of action recommended by the scoring system) – has there been stability in override decisions?

- Has the predictability of the level of defaults or approvals matched actual results?

Historically, banks have built their credit scorecards using default or partial data from the credit reference agencies. This has given the banks details of any credit agreements which are in default. In recent years, the use of full data has become more common where banks can see details of all credit agreements with other lenders, whether in default or not. Although strict rules apply around the use of full data, there are clear benefits in preventing lending to customers who cannot afford their total commitments.

Part Five

Credit Risk Management of SME Loans

Student Learning Outcomes

By the end of this chapter you should be able to:

- **Discuss the importance of credit risk management in SME financing**
- **Describe the loan eligibility and evaluation criteria in SME financing**
- **Describe the process of loan disbursal management for SME**
- **Differentiate between the loan disbursal process for SMEs and corporate borrowers**
- **Perform critical analysis of a credit approval package prepared for SMEs**
- **Explain the risk management techniques deployed by banks post loan disbursal**
- **Differentiate between the loan monitoring of SMEs and corporate borrowers**
- **Recall SBP lending guidelines and prudential regulations governing SME financing**
- **Recall the early warning signals to arrest past-due cases and explain their significance**

Importance of CRM in SME financing

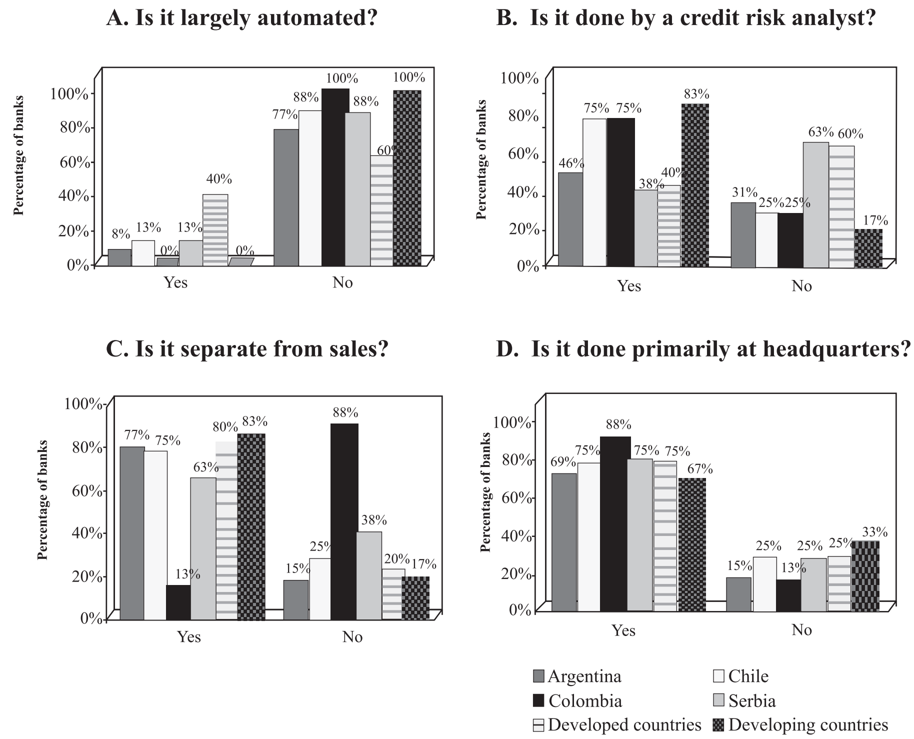
Small business lending has a strong positive effect on bank profitability. However, lending to SMEs is riskier than to large corporate, therefore, banks should develop credit risk models specifically addressed to SMEs in order to minimize their expected and unexpected losses. Many banks and consulting companies already follow this practice of separating large corporates from small and medium sized companies when modeling credit risk.

As they learn to deal with SMEs, banks are reorganizing their credit risk management systems, with the degree of sophistication

being greater among international banks and the leading, large domestic banks. The figure below shows some aspects of how banks are organizing their risk management processes related to SME lending as per a World Bank survey.

Risk management practices

This figure shows the percentage of banks that answered affirmatively or negatively to different options available regarding the structure of their credit risk management practices for the SME segment. Information for this figure was gathered through bank interviews conducted by the World Bank and the International Finance Corporation (IFC).



In most large banks, and with the exception of pure credit scoring, credit risk management is not automated. In most cases, it involves a credit risk analyst. Typically, risk management is a function that is organizationally separated from sales and is done primarily at headquarters. While maintaining independence in judgment, risk analysts and managers work cooperatively with those who sell products and originate loans (i.e., the SME account managers, in countries where business models are more advanced). In effect, risk analysts endeavor to train SME account managers and raise their risk awareness, so that the credit approval process is streamlined and loan application has a higher likelihood of not being rejected by risk analysts.

The World bank surveys suggest that large banks, particularly in Chile and Argentina and much less so in Colombia, use well-developed screening tools to sort out "good" debtors from the loan applicant pool. These screening tools are differentiated by firm or loan size. The size threshold for the applicability of a given

screening tool is typically determined by the effectiveness of the tool itself, as gauged by repeated experience. Thus, automatic scoring methods are usually applied to small companies with small loans (for which the owner and SME information is combined). Statistical analyses of the effectiveness of automated scoring is used to determine the threshold size beyond with it is deemed to lose potency, although efforts are continuously made to improve the scoring technique so to apply it to incrementally larger loans or firms. Streamlined and substantially standardized rating tools are used for larger loans or SMEs for which automatic scoring is deemed to be not effective. Such tools include quantitative and qualitative information and are typically developed by adapting (simplifying, streamlining, and standardizing) to the SME business the rating methods applied to large corporations. SME ratings do not lead to the automatic approval of loans, but they rather provide the basis for the risk analyst to evaluate loans and decide on their approval. After loans are approved, banks continuously monitor the loans and the SMEs (the larger ones in particular), plus they have an early warning system, with triggers, to anticipate and detect potential problems.

Loan eligibility and evaluation criteria in SME financing

The factors taken into consideration by all banks while evaluating loans to SMEs are represented by the "5 C's of credit" which are a common reference to the major elements of a banker's analysis when considering a request for a loan. Namely, these are:

1. Cash Flow
2. Collateral
3. Capital
4. Character
5. Conditions

1. Cash Flow:

The bank needs to be certain that the applicant's business generates enough cash flow to repay the loan that he is requesting. In order to determine this, the bank will be looking at the company's historical and projected cash flow and compare that to the company's projected debt service requirements. There are a variety of credit analysis metrics used by banks to evaluate this but a commonly used methodology is the "Debt Service Coverage Ratio" generally

defined as follows:

Debt Service Coverage Ratio = Earnings before interest, taxation, depreciation and amortization (EBITDA) – income taxes – unfinanced capital expenditure/Projected principal and interest payments over the next 12 months.

Typically, the bank will look at the company's historical ability to service the debt. This means the bank will compare the company's past 3 years free cash flow to projected debt service, as well as the past twelve months to the extent your company is well into its fiscal year. While projected cash flow is important as well, the bank will generally want to see that the company's historical cash flow is sufficient to support the requested debt. Usually projected cash flow figures are higher than historical figures due to expected growth at the company.

The banker will also want to see a comfortable margin of error in the company's cash flow. This margin of error is important since the bank wants to be comfortable that if there is a blip in the company's performance that the company will still be able to meet its obligations.

2. Collateral

In most cases, the bank wants the loan amount to be exceeded by the amount of the company's collateral. The reason the bank is interested in collateral is as a secondary source of repayment of the loan. If the company is unable to generate sufficient cash flow to repay the loan at some point in the future, the bank wants to be comfortable that it will be able to recover its loan by liquidating the collateral and using the proceeds to pay off the loan.

The bank is interested in only certain asset classes as collateral – specifically accounts receivable, inventory, equipment and real estate – since in a liquidation scenario, these asset classes can be collected or sold to generate funds to repay the loan. Other asset classes such as goodwill, prepaid amounts, investments, etc. will not be considered by the bank as collateral since in a liquidation scenario, they would not fetch any meaningful amounts. In the case of accounts receivable, the debtor is legally required to pay their bill with the company and in a liquidation scenario the bank will collect the accounts receivable and use those amounts to

settle the loan. In the case of inventory, equipment and real estate, the bank can sell these assets and use the proceeds to set off the loan.

Moreover, the bank will discount or "margin" the value of the collateral based on historical liquidation values. These are the amounts that in the bank's historical experience they have realized in a liquidation scenario against the respective asset class. In the case of equipment and real estate collateral the bank will need to have a third party appraisal completed on these assets. The bank will margin the appraised value of these asset classes to determine the amount of the loan, as opposed to using the company's carrying value of these assets on its balance sheet.

3. Capital

When it comes to capital, the bank is essentially looking for the owner of the company to have sufficient equity in the company. Capital is important to the bank for two reasons. First, having sufficient equity in the company provides a cushion to withstand a blip in the company's ability to generate cash flow. For example, if the company were to become unprofitable for any reason, it would begin to burn through cash to fund operations. The bank is never interested in lending money to fund a company's losses, so they want to be sure that there is enough equity in the company to weather a storm and to rehabilitate itself. Without sufficient capital, the company could run out of cash and be forced to file for bankruptcy protection.

Secondly, when it comes to capital, the bank is looking for the owner to be sufficiently invested in the company such that if things were to go wrong, the owner would be motivated to stick by the company and work with the bank during a turnaround. If the owner were to simply hand over the keys to the business, it would clearly leave the bank fewer (and less viable) options on how to obtain repayment of the loan.

There is no precise measure or amount of "enough capital" but rather it is specific to the situation and the owner's financial profile. Commonly, the bank will look at the owner's investment in the company relative to their total net worth, and they will compare the amount of the loan to the amount of equity in the company – the company's Debt to Equity Ratio. This is a measure of the company's total

liabilities to shareholder's equity. Banks typically like to see Debt to Equity Ratios no higher than 2 to 3 times.

4. Conditions

Another key factor in the five C's of credit is the overall environment that the company is operating in. The bank is going to assess the conditions surrounding the company and its industry to determine the key risks facing the company and also, whether or not these risks are sufficiently mitigated. Even if the company's historical financial performance is strong, the bank wants to be sure of the future viability of the company. In this assessment, the bank is going to consider the following:

- **The competitive landscape of your company:** who is the company's competition? How does the company differentiate itself from the competition? How does the access to capital of the company compare to its competition and how are any risks posed by this mitigated? Are there technological risks posed by the competition?

- **The nature of the company's customer relationships:** are there any significant customer concentrations (do any of the customers represent more than 10% of the company's revenues?) If so, how does the company protect these customer relationships? What is the company doing to diversify its revenue base? What is the longevity of customer relationships? Are any major customers subject to financial duress? Is the company sufficiently capitalized to withstand a sizable write-down if they can't collect their receivable from a bankrupt customer?

- **Supply risks:** is the company subject to supply disruptions from a key supplier? How is this risk mitigated? What is the nature of relationships with key suppliers?

- **Industry issues –** are there any macro-economic or political factors affecting the company? Could the passage of pending legislation impair the industry or company's economics? Are there any trends emerging among customers or suppliers that in the future will negatively impact operations?

5. Character:

The importance of character cannot be stressed enough. Character gets to the issue of people – are the owner and management of the company honorable people when it comes to meeting their obligations? Without scoring high marks for character, the bank will not approve the loan.

How does a banker assess character? After all, it is intangible. It is partly fact-based and partly “gut feeling”. The fact-based assessment involves a review of credit reports on the company and the personal credit report of the owner as well. The bank will also communicate with the company’s current and former bankers to determine how it has handled its banking arrangements in the past. The bank may also communicate with the company’s customers and vendors to assess how it has dealt with these business partners in the past.   .

Banks want to deal only with people that they can trust to act in good faith at all times - in good times and in bad. Banks want to know that if things go wrong, that the owner will be there and do his best to ensure that the company honors its commitments to the bank. Even if the company’s financial profile is strong and the company has scored well in all of the other “Five C’s of Credit”, the bank will turn down the loan if the character test is failed. It is not necessarily an issue if the company has gone through troubled times in the past. What is more important is how it dealt with the situation. Was it forthright and proactive with the bank in communicating problems? Or did it wait until a default situation was already in effect before reaching out to the bank?

To summarize, the 5 C’s of credit forms the basis of the banker’s analysis for loan eligibility and evaluation for SME clients. The bank needs to be sure that:

(1) the company generates enough **CASH FLOW** to service the requested debt,

(2) there is sufficient **COLLATERAL** to cover the amount of the loan as a secondary source of repayment should the company fail,

(3) there is enough **CAPITAL** in the company to weather a storm and to ensure the owner’s commitment to the

company,

(4) the **CONDITIONS** surrounding the business do not pose any significant unmitigated risks, and;

(5) the owners and management of the company are of sound **CHARACTER**, people who can be trusted to honor their commitments in good times and bad.

In terms of the specific factors that banks consider in evaluating loans, a World Bank survey indicates that the financial assessment of the business is the most important consideration by banks across all firms. A firm's credit history with the bank is the second most important criterion, with the owner's characteristics and the purpose of the loan being next in importance. Most notably, foreign-owned banks tend to base their decisions more on the financial assessment of the business than domestic-owned banks. This is consistent with privately-owned banks being better able to screen customers using soft information and foreign-owned banks relying mostly on hard, quantifiable information. Moreover, given that the informational and institutional environment is weaker in developing countries, a slightly higher percentage of banks require collateral to make business loans in these countries relative to banks in developed countries. Real estate is the most frequently accepted type of collateral for business lending, regardless of firm size. Cash and other liquid assets are the second most important forms of collateral used across all firm sizes followed by bank and personal guarantees.

Another survey of financial institutions throughout The Association of Southeast Asian Nation (ASEAN) revealed that many banks and non-bank institutions are generally keen to lend to SME as they realize that on a portfolio basis, SME loans provide higher returns and lower risk compared to large corporate loans. The financial institutions felt that, to ensure more successful applications and increase their market share, they should make the criteria for evaluating finance applications more appropriate to the SME market, particularly as far as the requirement for collateral is concerned. They recognize the need to be more lenient in assessing applications, the need to take more risk, offer advice and support to SMEs and the need to offer products which are new, more appropriate to SME financing needs, more broad in spectrum and with improved costs and value.

The survey found that some financial institutions are risk adverse to lending to informationally opaque SME, while others simply do not have the skills needed to understand and evaluate SME. In some large banking institutions, the prevailing mindset is still one of 'bigger is better'. As a result, they demand for collateral, require tedious documentations and subject the SME to the same evaluation criteria as they would large and structured corporations. The poor information environment in many ASEAN countries does not help either. Non-bank financial institutions (such as finance or credit companies) and smaller boutique banks are usually found to be more perceptive and knowledgeable about SME financing than their larger counterparts. However, a positive trend is appearing among financial institutions – armed with the lessons learnt from the Asian Crisis and faced with greater competitive pressure, they are increasingly looking to increase lending to medium and small sized enterprises. The availability of newer technologies such as credit scoring has facilitated the progress of some banks' foray into this segment.

The State Bank of Pakistan has relaxed the lending policies of SMEs to a major extent, so that this sector may develop to its true potential. SBP has allowed uncollateralized lending for loans up to Rs 3 million and without financial statements for loans up to Rs 10 million. Despite the new legality of this lending, the lending practice is proving too risky for conservative Pakistani banks. Prudential Regulation R-5 mentions that banks are free to determine the margin requirements on facilities provided by them to their clients taking into account the risk profile of the borrower in order to secure their interest. In Regulation R-9, it is mentioned that the bank should ensure that the loans have been properly utilized by the SMEs and the banks should develop an appropriate system for the utilization of loans. SME Prudential Regulations also state that if SMEs do not maintain financial documentation as this sector is not much developed to maintain detailed financial records then banks may project future cash flows of SMEs to provide them loans.

Bank procedures and policies used for SME lending are too complex, making them time consuming and costly for both parties. Banks apply the same rules and policies to small enterprises as they apply to large corporations; as a result, a typical small business loan requires numerous steps for the bank and various meetings with clients. Total time taken to

obtain a loan can vary from 30 to 45 days on an average. Such long and expensive procedures limit the number of loans that can be made a month per loan officer. Furthermore, it translates into missed business opportunities for SMEs because the manager/employee must spend time away from the business to complete procedures to obtain a loan. In addition to these high transaction costs, indirect costs in terms of legal fees, collateral registration and documentation make bank lending expensive for SMEs.

Loan Disbursal Management

The loan processing function comprises all activities in the course of credit approval and inventory management processes that do not include risk analysis activities. There are basically two options:

- Risk analysis and sales employees carry out loan processing activities in addition to their other tasks.
- Loan processing is carried out by separate employees (loan officers).

In choosing between the two options, it is necessary to weigh:

- the learning effects to be achieved by specialization;
- the rate differentiation that becomes possible; and
- the possibility of focusing credit analysts and sales employees on their core activities against the coordination problems that may arise as a result.

The number of claims to be processed underlying each credit approval process is an important input factor in this consideration. The increasing standardization and automation of credit approval processes has, at least in some processing segments, resulted in the risk analysis function resembling the loan processing function or actually rendered the processing function obsolete.

While this particular process segment is thus characterized by a situation in which the move to a centralized loan processing unit has already been rendered obsolete by new technological developments, the insufficient number of claims poses an obstacle to the introduction of separate loan processing units in other processing segments. Therefore, units with low numbers of claims and high degrees of standardization and automation generally do not separate risk analysis and loan processing units. In these cases,

one-stop processing is regarded as more expedient, efficient and simpler. By contrast, the separation may make sense in case of a high need for specialized know-how or in case of sufficiently large numbers of claims in combination with a small proportion of automated processes.

Loan processing has to be distinguished from simple paperwork and general organizational activities. The employees charged with these tasks are nowadays often managed as separate clerical units that are flexible in executing jobs from several risk analysis and processing units.

Loan Disbursal Process

Following is the general process that all banks follow for SME loan financing. It may, however, vary from bank to bank.

- When applying for a loan, the applicant submits:
    - Loan Application Form
    - BBFS (Basic Borrowers Fact Sheets)
    - Information related to existing financing being availed from other financial institutions and security giventherein.
- The credit department / relationship team assesses the information provided in this form and confirms if it is in accordance with the Prudential Regulations for SMEs. If they find the information satisfactory, the applicant is called for a meeting. This process may take a week for completion.
- The credit officer visits the business site of the client to check the business viability of the project. The client may be asked to provide evidence of his cash flow to prove his business's financial standing for e.g. books of accounts, stock reports, etc.
- The officer understands the business model of the client and discusses the financing facilities for the SME (facilities may differ from the credit needs of the borrower).
- The credit department carries out evaluation and appraisal of the loan request.
- The bank obtains legal opinion certificate from the lawyer for clearance of the title of deed (client's property) and gets the

property evaluated by professional valuator on the bank's approved panel.

- If all turns out to be acceptable, the case is forwarded to the Risk Department for their approval and sign off.

- If the loan is not sanctioned, the bank informs the customer about the fate of his application. The Bank may or may not disclose reasons for rejecting a grant of loan.

  If the loan proposal is approved, then:

  - Customer is officially informed about the approval via an official letter clearing stating the allowed facilities and the security to be provided by the borrower.

  - In pre-disbursement stage, legal documents are prepared and executed.

  - The collateral is mortgaged in bank's favour.

  - The business assets are insured i.e. stocks, machinery etc.

- Documentation is completed and submitted to the Credit Administrative Department forsafe-keeping and limits are fed into the system. The loan is thus disbursed.

Segmentation of Credit Approval Processes

In order to assess the credit risk, it is necessary to take a close look at the borrower's economic and legal situation as well as the relevant environment (e.g. industry, economic growth). The quality of credit approval processes depends on two factors; a transparent and comprehensive presentation of the risks when granting the loan on the one hand and an adequate assessment of these risks on the other. Furthermore, the level of efficiency of the credit approval processes is an important rating element. Due to the considerable differences in the nature of various borrowers (e.g. private persons, listed companies, sovereigns, etc.) and the assets to be financed (e.g. residential real estate, production plants, machinery, etc.) as well the large number of products and their complexity, there cannot be a uniform process to assess credit risks. Therefore, it is necessary to differentiate and this section describes the essential criteria which have to be taken into account in defining this differentiation in terms of risk and efficiency.

Accounting for Risk Aspects

The quality of the credit approval process from a risk perspective is determined by the best possible identification and evaluation of the credit risk resulting from a possible exposure. The credit risk can distributed among four risk components which have found their way into the new Basel Capital Accord (in the following referred to as Basel II).

- Probability of default (PD)
- Loss given default (LGD)
- Exposure at default (EAD)
- Maturity (M)

The most important components in credit approval processes are PD, LGD and EAD. While maturity (M) is required to calculate the required capital, it plays a minor role in exposure review. The significance of PD, LGD, and EAD is described in more detail below.

Probability of Default

Reviewing a borrowers probability of default is basically done by evaluating the borrowers current and future ability to fulfill its interest and principal repayment obligations. This evaluation has to take into account various characteristics of the borrower (natural or legal person) which should lead to a differentiation of the credit approval processes in accordance with the borrowers served by the bank. Furthermore, it has to be taken into account that, for certain finance transactions, interest and principal repayments should be financed exclusively from the cash flow of the object to be financed without the possibility for recourse to further assets of the borrower. In this case, the credit review must address the viability of the underlying business model, which means that the source of the cash flows required to meet interest and principal repayment obligations has to be included in the review.

Loss Given Default

The loss given default is affected by the collateralized portion as well as the cost of selling the collateral. Therefore, the calculated value and type of collateral also have to be taken into account in designing the credit approval processes.

Exposure at Default (EAD)

In the vast majority of the cases, the exposure at default corresponds to the amount owed to the bank. Thus, besides the type of claim, the amount of the claim is another important element in the credit approval process. Thus, four factors should be taken into account in the segmentation of credit approval processes:

1. type of borrower

2. source of cash flows

3. value and type of collateral

4. amount and type of claim

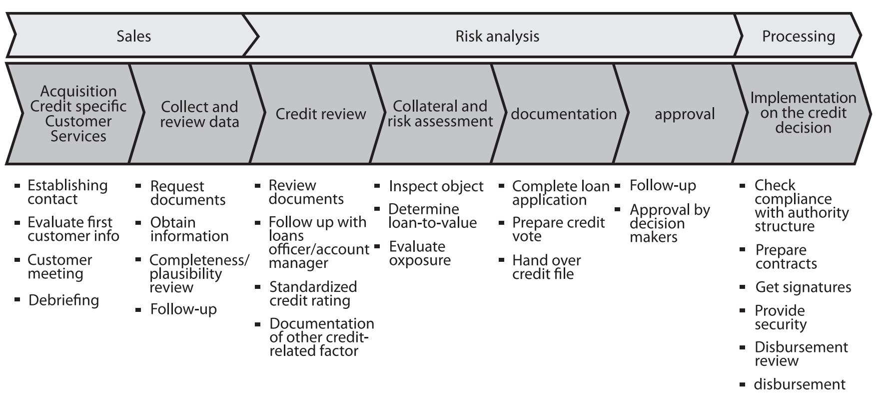
Object of Review and Exposure Management

Credit approval processes are started on behalf of a credit applicant. Especially in the context of lending to corporate customers, it is often necessary to include several (natural or legal) persons in the credit rating process. This will be required if these (natural and legal) persons are to be considered one economic unit and would thus probably have a mutual impact on each others credit standing. In practice, granting an individual loan often involves a large number of (natural and legal) persons. This has to be borne in mind throughout the entire credit approval process but particularly in the course of the credit review.

Credit approval for groups of companies should be designed in a manner which is specific to the risk involved and efficient and should aim to focus the review on the actual risk-bearer, the (natural or legal) person whose legal and economic situation ultimately determines the ability to fulfill the obligations under the credit agreement. In any case, Basel II requires the assessment of the borrowers credit standing.

The Credit Approval Process Is Subdivided into a Large Number of Individual Process Steps

Conceptual presentation individual process



Loan Monitoring and Risk management techniques

Throughout the contractual relationship between the credit institution and its borrowers, economic developments may bring about changes that have an impact on risk. Banks should monitor their credit exposures continuously to detect such changes in time. In general, this is done by means of so-called periodic and regular checks. Individual exposures are checked at fixed periodic intervals. Many banks integrate these checks in the roll-over of credit exposures which becomes due as periods expire.

In order to detect risks already prior to the periodic check to be carried out due to the expiry of a specified term, many banks use early warning systems. Based on early warning indicators which have to be defined for each segment, a differentiated review process is triggered. Among other things, these early warning systems take into account defaults with regard to the contractual relationship between bank and borrower. Of great importance here is the insufficient performance of interest and principal repayment obligations. In order to react to these situations, banks have set up reminder procedures to inform the debtor of the default.

Periodic Reviews and Roll-over

The processes governing the design of periodic reviews and roll-over differ only in a few aspects. The terminological distinction is based on different process triggers. While periodic reviews are carried out at intervals to be determined in the internal guidelines, the roll-over is triggered by the expiry of a contractually agreed period. In practice, banks try to carry out upcoming roll-over in the course of the periodic review. If it is not possible to do both at the same time, the internal guidelines may stipulate a period after the most recent review during which a roll-over can be carried out without the need for a new credit review. If this period has expired, the process of periodic review also has to be conducted in case of a roll-over. The only difference between a periodic review and a roll-over is that the latter offers the possibility to agree to changes in the contractual stipulations of the credit exposure with the customer (e.g. new conditions) or to terminate the exposure properly.
Typically, a periodic reviewed is carried out at one-year interval starting from the date of credit approval. For companies preparing financial statements, the periodic review should be carried out as shortly after the balance sheet date or the date of submitting the balance sheet as possible. The review of credit exposures should comprise four major activities:

- assessing the personal and economic situation of borrowers

based on current data;

- adapting the rating, if applicable;
- checking and evaluating the available collateral;
- checking and modifying the conditions

The review should focus on the development since the most recent approval or review. The decision-making structure should stipulate who is responsible for periodic reviews. In most cases, it will be that level of authority which would also be in charge of approving new credit applications. The review of standardized credits usually comprises small-volume credit exposures for which the rating process has determined a low probability of default. The internal guidelines have to define the limits of automated review based on exposure volume, credit standing and type of credit. The additional review triggered by risk signals from the early warning system makes up for the manual check which is not carried out here.

Just like the review of standardized credits, the abbreviated review is a tool used for reasons of efficiency. Here too, a full and comprehensive review of the credit exposure is not carried out. In general, the banks just update the review-related documents and use a short, standardized questionnaire which has to be completed by the employee from the credit analysis department responsible for the exposure. This questionnaire confirms the receipt of the review-related documents and the plausibility check of these documents. Typically, the questionnaires relating to the abbreviated review process contain checklists to check the data received for validity and plausibility. The following list is an example of the content of a questionnaire relating to the abbreviated review process :

- received balance sheet/statement of receipts & disbursements and plausibility check
- checking debt service capacity
- reviewing account movements
- checking and assessing significant deviations of financial figures or personal data compared to the previous review of the exposure.

A detailed layout of the questionnaires must be present in the internal guidelines. In any case, there should also be guidelines stipulating a full review in case certain credit assessment changes occur. The decisive factor for the range of application of the abbreviated review process is, as was already the case for the review of standardized credits, the existence of an early warning system. The early warning system makes up for the comprehensive review which is not triggered by risk signals and is not carried out here.

A full review comprises a comprehensive review of the borrower's economic and personal situation in analogy to a new credit application. The division of tasks between sales and credit analysis/processing is typically the same as that for the preparation of the credit proposal for new transactions. In addition to the classification into three process types described earlier, a differentiation in the documentation of the review can also simplify the task of the credit officers.

Risk-triggered Reviews — Early Warning Systems

The events triggering a review of credit exposures described above are independent of the occurrence of risk signals arising from the business relationship with the borrower. Risk-triggered reviews, by contrast, are contingent on the actual occurrence or the assumption of negative criteria with regard to the borrower's credit standing also in between review dates.

Development

In many cases, an unscheduled review of credit exposures is carried out after receiving informal notification concerning new details about the customer from the account manager or third parties. This individual approach, however, should be complemented by a standardized and automated trigger process. This is usually done within the framework of so-called early warning systems. The immediate goal is the consistent and uniform trigger of the review process and thus a reduction of the individual process and assessment risk.

Reminder Procedures

In case of default on interest or principal repayment on the part of a borrower, a formal reminder procedure has to be initiated. Reminder procedures are part of the credit monitoring of individual credit exposures. In order to avoid forgetting to send out reminders, credit institutions should apply standardized and automated reminder procedures. If the IT system registers the

occurrence of a default on interest or principal repayment, a collection letter should automatically be sent to the borrower. The length of the waiting period has to be stipulated in the internal guidelines and implemented in the systems. This ensures that collection letters are sent out in time in every case.

Furthermore, tight reminder deadlines are useful for risk considerations. This is true in particular as the lender's position may deteriorate compared to other creditors of the borrower during this period. In order to make collection letters as effective as possible, some banks use a discriminating approach which is based on the classification of the borrower identified by an early warning system. Typically, both the wording of the text and the payment deadline are modified accordingly. For business reasons, it is possible to exclude certain customers from the standardized reminder procedures (individualized reminder procedures). The prerequisites for an individualized reminder procedure have to be stipulated in detail in the internal guidelines. It is important that no general exception is made for entire groups of customers. Quite on the contrary, the exception should apply only to those customers whose contributions to earnings justify the resulting risk and the associated process cost. Therefore, the rules should define minimum contribution margins. If the individualized process, usually in the form of a personal conversation with the borrower,does not yield any results, the standardized reminder procedure should be initiated.

Intensive Servicing and Handling of Troubled Loans

If a borrower's credit standing deteriorates, the bank should interfere in the standardized servicing process and try to control credit risks that are imminent or have already taken effect. This should ensure that adequate measures to secure claims can be taken in time. The objective is not only an improved collateral position of the lender compared to other creditors (caused by the time gained by taking early precautionary measures) but also an effective restructuring of the borrowers debt, thus preventing the total loss of the credit exposure. It does not make economic sense to continue the credit exposure, the workout of the exposure and the resulting sale of the collateral should be initiated.

Risk Provisions

Finally, the processes concerning the set-up of specific loan loss provisions as well as recording the write-off of claims are discussed below.

Setting up Specific Loan Loss Provisions

For reasons of completeness and easy access, the fundamental regulations governing the determination of specific loan loss provisions should be contained in the internal guidelines. The set-up of specific loan loss provisions requires a forecast including all factors that can be expected to affect the extent of the provisions. Furthermore, the determination of the reduction in value requires the valuation of the collateral associated with the exposure. In accordance with the lending principles stipulated in the internal guidelines, the current loan-to-value ratio forms the initial value used to determine the collateral value. If there are any doubts about the actual value, the loan-to-value ratio has to be reviewed and modified if necessary. The internal guidelines should lay down the possibilities to determine loan-to-value ratios in the set-up of specific loan loss provisions. This lending value may be reduced from case to case to account for the marketability of the asset as well as an objective assessment of the sales prospects at the balance sheet date. The employee in charge has to justify the reduction in value in the credit files. Furthermore, it has to be ensured that the realization costs are taken into account when determining the collateral value relevant for the specific loan loss provision.

The set-up of specific loan loss provisions is subject to special documentation requirements. This should help avoid inquiries and duplicate efforts with regard to an external review. In general, the request for setting up a specific loan loss provision is filed by the employee in charge of the exposure in credit approval processing in coordination with the account manager responsible. Provisions for exposures that have already been transferred to restructuring or workout are set up by the employees managing the exposures in those departments.

Write-offs

Write-offs of claims refer to those amounts by which claims are reduced as a result of becoming uncollectible. This includes direct write-offs as well as the utilization of specific loan loss provisions. The exposure should be written off if:

- the collateral of the related exposure has been realized in full or is of no value; or
- the claims were waived in part or in full, and

- no more payments on the remaining claim are to be expected.

Stipulations governing the decision-making authority have to be laid down in the internal guidelines. The request for a write-off of claims should include the presentation of the reasons for the default. Furthermore, it should contain a statement as to whether the claim should be pursued any further. The claims should be recorded in a central list of defaulted claims which is uniform for the bank as a whole. Depreciation and provisions should be recorded continuously, also throughout the year.

Risk Monitoring Systems and Early Warning Systems

Risk monitoring aims at checking compliance with the risk strategy and ensuring the effectiveness of counter measures. Early warning helps detect situations in which limits are exceeded or marked changes in the risk position, be it at the level of the total portfolio or individual loans, in time and it is used to generate warning signals for risk controlling.

Experience has shown: that the earlier risks are detected, the more effectively they can be countered. In the individual loan segment, for example, the (partial) repayment of the exposure or the proceeds from the realization of collateral is usually higher the earlier the loans risk of default is detected. The same is true at a portfolio level: The earlier it is realized that the portfolios risks reach the limits defined under the risk strategy, the more effectively can be reacted. Warning signals should be generated before the limits are fully reached in order to make it possible to make use of all (levels of) risk mitigation measures. If the warning is generated in time, limits are not exceeded, and there is no need to approve such exceeding of limits in retrospect.

The information itself, however, is not sufficient; it is also necessary to trigger risk controlling processes in time. Thus, the requirements on risk monitoring and early warning system are, on the one hand, the timely, automated generation of warning signals, and the triggering of processes for increased risk monitoring or risk mitigation on the other.

Risk Controlling Systems

Risk controlling systems are used to capture the bank’s actual and forecast risks, to align them with the limits and other guidelines of the risk strategy and based on this, to initiate measures that limit the risks, if necessary. Risk controlling systems are used to submit regular reports about the bank’s risk situation to the hierarchical level in charge as a decision basis. In order to make the management process effective, it is absolutely necessary that the systems generate an automatic warning if the defined limits are

exceeded, initiate risk mitigation processes and in case the limits are exceeded for an extended period of time, trigger escalation processes to the next decision-making level. Sophisticated systems support the integration of risk management in bank-wide capital allocation. These systems are intended to establish a link between the management of individual transactions and portfolio management. All information concerning individual transactions are collected by the systems and made available to portfolio management and risk management control. Ideally, the systems link the credit approval decision with portfolio management in terms of defining conditions and limits.

Things to Do Before Loans Become Non-performing

The health of a financial institution largely depends on the quality of its assets, including the loans it extends. Loans typically involve credit extended on the basis of a contract that is held by the originating institution until maturity. It is therefore good international practice and most countries require banks to classify their assets, especially loans, in one of five categories:

1. **Acceptable** – a loan with no detectable problems, in which the associated risks are unlikely to materialize over time.

2. **Special Mention** – a loan with material weakness that nonetheless does not warrant the expectation of a loss or a substandard classification.

3. **Substandard** – a loan for which neither the borrower's financial condition nor the security or collateral package backing the loan would be adequate to protect the lender from loss.

4. **Doubtful** – a substandard loan with the added risk that any attempts to liquidate value and to collect on it are unlikely to generate enough to recover the lender's capital.

5. **Loss** – a loan deemed uncollectible, because any assets backing the loan are gone or have lost their original value, and the borrower's means to repay the loan are impaired. The loan may still have salvage value, but the effort required to realize that value is beyond that considered reasonable, which justifies the lender writing off the remaining outstanding balance.

Some financial institutions use additional categories, which should take into account the readiness of the organization to prescribe remedial or informative actions in connection with the extra

categories. If the institution's formal response to changes in loan classification is basically the same for each category across a wide range of loan classification categories, then the value of those extra categories may be questionable. In fact, they may consume too much of the staff 's time in trying to refine the classification with no real differentiation based on purposeful action or response. Following are the guidelines for loan classification provided in SBP in the Prudential Regulations for SME:

GUIDELINES IN THE MATTER OF CLASSIFICATION AND PROVISIONING FOR ASSETS (REGULATION R-11)

All Financing Facilities (including Short, Medium and Long Term)

CLASSIFICATION (1)	DETERMINANT (2)	TREATMENT OF INCOME (3)	PROVISIONS TO BE MADE (4)
1. Substandard	Where mark-up/ interest or principal is overdue by 90 days or more from the due date.	Unrealized mark-up/interest to be kept in Memorandum Account and not to be credited to Income Account except when realized in cash Unrealized mark up/interest already taken to income account to be reversed and kept in Memorandum Account	Provision of 25% of the difference resulting from the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and 40% of the Forced Sale Value (FSV) of pledged stocks and mortgaged properties (see Note 2 below).
2. Doubtful	Where mark-up/ interest or principal is overdue by 180 days or more from the due date.	As above	Provision of 50% of the difference resultingfrom the outstanding balance of principal less the amount of liquid assets realizable without recourse to a Court of Law and 40% of the Forced Sale Value (FSV) of pledged stocks and mortgaged properties (see Note 2 below).
3. Loss	(a) Where mark-up/ interest or principal is overdue by one year or more from the due date.	As above	Provision of 100% of the difference resulting from the outstanding balance of principal lessthe amount of liquid assets realizable withoutrecourse to a Court of Law and 40% of the Forced Sale Value (FSV) of pledged stocks and mortgaged properties (see Note 2 below).Benifit of FSV against NFLs shall not beavailable after 3 years from the date of classification of the Loan/Advance. However, the 40% benefit of FSV of land (open plot and separate valuation of land if building is constructed) shall be available for four years from the date of slassification of loan
	(b) Where Trade Bills (Import/Export or Inland Bills) are not paid/adjusted within 180 days of the due date.	As above	As above

- **Disseminating bank-wide guidance on warning signs and indicators**

  An important feature of any sound risk management system is consistent treatment of individual loans and borrowers across the entire portfolio. If the staff are free to pick and choose which factors they deem important with no guidance as to a common approach, loan assessments could then vary across the classification spectrum. Without guidance as to the significance of different warning signs and how to apply this information to assigning loan categories, even the most ambitious loan classification system can produce

questionable information.

Best practice entails broad dissemination of the signs indicating potential borrower distress and delinquency. One way of categorizing warning signs is according to a company's:

1. Operations
2. Behavioral and management aspects
3. Reporting
4. Investing activities
5. Financing activities

When taken alone, many of these signs, listed in the table below, may not indicate problems or they may be temporary. Often, only analysis allows us to observe combinations of signs that may validate the warning of ongoing or potential distress.

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	(b) Where Trade Bills (Import/Export or Inland Bills) are not paid/adjusted within 180 days of the due date.	As above	As above

WARNING SIGNS

Operations

1. Steady decline or rapid increase in sales
2. Frequent cash shortages
3. Significant changes in networking capital
4. Unexpected changes in strategy or business
5. Shrinking cash margins and unexpected losses
6. Unrealistic pricing/discount policy
7. Frequent revenue/earning shortfalls
8. Increasing dependence on fewer customers
9. Negative operational cash flow with net profits
10. Deteriorating accounts receivable
11. Increased credit to affiliated companies
12. Lengthening terms of settlement for payables
13. Repeated changes in suppliers
14. Insufficient cash to take trade discount
15. Inventory buildup with turnover slowing
16. Outmoded production or distribution systems
17. Inadequate spending on critical activities
18. Failure to pay taxes
19. Non-renewal or cancellation of insurance
20. Billing practices are deficient

Management and Behavior

1. Poor or deteriorating sponsor reputation
2. A lack of management/sponsor vision
3. Increasingly authoritarian management/board style
4. Senior executives not providing financial information
5. Incompetant finance director or CFO
6. Management experience/skill deficiencies
7. Management and shareholder contentiousness
8. Frequent changes in ownership and key positions
9. Sponsors'/managers' unexplained new wealth
10. Quarrels between company and its auditors
11. Notable shabbiness/loss of pride in company
12. Personal issue constraining management team

Reporting

1. Worsening delays in financial reporting
2. Poor quality of, or inconsistencies in, reports
3. Qualified audit opinions and/or audit disclaimers
4. Unexpected and/or untimely changes in auditors
5. Many unusual items in financial ststements
6. Revaluation of assets without convincing explanations
7. Padding of financial statements (mainly on the Balance Sheet)
8. Increasingly changing interim financials with surprises
9. Major unexplained planned vs. reported results gaps
10. A deterioration in rating by external analysis
11. Regular breaches of financial covenants
12. Increasing incidence of waiver requests

Investing

1. Non-current assets increase faster than revenue/profit
2. Major procurement without proper rationale/financing
3. Working capital needs funded by assets sales
4. Inventory build-up without sound inventory controls
5. Seemingly speculative inventory purchases
6. Inadequate maintenance of plant and equipment

Financing

1. High or increasing levels of financial leverage
2. Increased short-term funding for long-term liabilities
3. Difficulties in accessing financing
4. Excessive lending to related individuals/affiliates
5. Obligations to creditors not fully met each cycle
6. Increasing customer/creditor complaints/ legal action
7. Funding secured on less favorable terms

- **Signs of distress in the borrower and in the loan should be seen in combination**

The process of accurately diagnosing a borrower's financial condition involves identification of groups of warning signs that validate one another. Taken alone, most warning signs are too ambiguous to signal financial distress.

For example, Company ABC has experienced a recent acceleration of sales over the past several quarters and you question the company's CEO on this point. The CEO in turn questions why you are asking about such an obvious sign of success. Without additional information, you are not in a position to argue for an alternative interpretation. However, if any of the following warning signs were observed in conjunction with the rapid increase in sales, the story they would tell would be quite different:

- **Declines in profit margins** – might signify that the higher sales were achieved from prices that are too low, overly generous discounts or rebates, higher selling costs, or some combination thereof.

- **Pronounced increases in product returns** – might indicate that higher sales resulted from lapses in quality control, which would have a negative impact on profits, with a time lag as dissatisfied customers return their purchases. It could even involve government-enforced product safety recalls.

- **Pronounced increases in the aging of accounts receivable** – might identify additional sales achieved by extending store or company credit without adequate credit scrutiny or safeguards. The additional costs of collection and losses on extended credit could have a negative impact on company profits with a time lag.

- **Loan and loan portfolio reporting requirements and frequency**

Portfolio staff should be given clear instructions regarding the frequency and topical coverage of portfolio supervision or monitoring reports. Such supervision reports typically include:

- **Loan terms, loan and interest payment history, borrower attributes, security profile:** Addresses who was intended to use the credit and why, relating the borrower's main characteristics to the nature of the business or project.

- **Credit risk review:** The review is an analysis of the risks affecting the borrower's ability to repay. It includes industry risk, country risk, legal risk, operational risk, etc., along with factors that might influence willingness to repay the loan.

- **Liquidity risk review:** For borrower company's assets and liabilities, with particular attention focused on the actual liquidity of those short term assets on which the borrower will likely depend to meet his regular cash requirements.

- **Market risk review:** Pertains to the risks inherent in

the market for the company's obligations (debt) and other claims on its cash (equity).

- **Security/collateral adequacy review**

  Adequacy of the information systems provides regular information on the above points. The different frequencies and levels of detail related to loan and loan portfolio reporting will vary in terms of costs and benefits. Best practices usually involve comprehensive portfolio reviews held semi-annually, with more focused reviews quarterly or monthly, depending on the extent to which the portfolio has loans in jeopardy and shows signs of other loans having potential for future problems. Well-focused reviews can help make sure that loan monitoring does not create a cost burden or demand excessive staff time. "Focus" is driven by the quality and effectiveness of the bank's loan classification system and its guidance regarding warning signs. It should also cover all relevant areas of risk management. In fact, these systems and processes are best viewed by bank management and staff as incomplete work-in-progress, to be fine-tuned through continuous feedback. It is crucial to prioritize well before the first signs of distress actually crystallize.

- **Portfolio-level actions**

  The lender should ensure that its information systems have the right balance between entity-level (borrower, loan, property) information and portfolio-level information. Information such as the number of loans outstanding with a single obligor or company group – or the number of loans that involve co-lending or counterparty risk with another financial institution – may be just as important for risk management as being able to drill down to yet a further level of operational or financial detail for an individual borrower. This may become even more important during a financial crisis. Reducing system blind spots before a financial crisis unfolds will make it easier for management to protect value during difficult times. When faced with a systemic financial crisis, staff are unlikely to have time for the broader information-gathering necessary to improve a portfolio.

Part Six

Making SME financing a larger portion of bank lending

Student Learning Outcomes

By the end of this chapter you should be able to:

- **Describe the importance of SME financing from bank's perspective.**
- **Discuss the challenges faced by banks in SME financing and evaluate the need to overcome them.**
- **Discuss the need for banks to market SME financing products to the customers.**
- **Discuss the benefits that can be earned in terms of boosting the industrialization process and enhancing the export sector by lending to SMEs.**
- **Describe the impact that SME financing can have on reducing employment and improving balance of payments situation in a country.**
- **Explain how banks can achieve diversification of loan portfolio.**
- **Demonstrate the strategies that banks take to create awareness about SME financing.**
- **Explain the different marketing tools that can be used to attract SMEs to financing.**
- **Discuss the need to incorporate flexibility and customization in products being offered to SME customers.**

The importance of SME financing and need for banks to focus on this segment

The SME sector is important to national economies because it contributes significantly to employment and GDP and because its growth is linked with the formalizing of an economy. In many countries, the majority of jobs are provided by SMEs. In the 30 high-income countries of the Organization for Economic Cooperation and Development (OECD), SMEs represent over

two-thirds of formal employment. In low-income countries, this figure tends to be smaller, especially where the informal sector is large; but it is still significant. Bank service of the SME sector is economically valuable because of the sector's importance in each country. Following are some of the contributions that SMEs make that indicate the need for banks to focus on this segment:

- **Engine of growth:**

  The SME sector's contribution to GDP also confirms its economic importance. In high-income countries, and some middle-income countries, the sector accounts for over half of national output. In low-income countries too, SMEs play a sizable role, though the informal economy is more dominant. The fact that the role of SMEs in an economy appears to increase with country income level might indicate that SMEs are themselves a driver of economic growth. Their allocative efficiencies in resource utilization such as labour, capital and technology synergize the economic development in a socially equitable manner. SMEs do allow a large number of entrepreneurs and self-employed to survive and exist. It is also understood that sectors dominated by SMEs are better able to exploit dynamic economies of scale. More importantly, there has been no successful transformation evidence available in the world without the active participation of SME sector in the economic development.

- **Essential for a competitive & efficient Market:**

  SMEs have got greater flexibility and high turnover with an easy entry and exit characteristic leading to larger number of SMEs in an economy. Consequently, the chances of greater efficiency become higher through competition among large number of enterprises. SMEs not only complete the supply chain but also work as nursery for larger firms. Moreover these enterprises as sub-contractors of large firms play a critical role in the efficient working of large firms.

- **Poverty reduction & equitable income distribution:**

  SMEs play a key role in providing additional employment and facilitating transformation of economy from low to middle income group. SMEs are considered relatively more labour intensive and their employment creation characteristic make them critical for poverty reduction and equitable

distribution of resources. These enterprises are considered an important source of employment for young, unskilled and women and therefore can contribute significantly towards the inclusive growth of any economy.

- **Boosting the industrialization process:**

  The promotion and development of the SMEs is a critical building block to an economy's industrialization agenda. SMEs tend to dominate a country's new and fast growing industries. Economies which discourage SMEs in any general sense are therefore likely to discourage some newer dynamic industries from putting down the roots they might otherwise do. In this respect, and in others, SMEs are associated with dynamism. Hence, it is imperative that the government provides an enabling environment for the growth and development of SMEs in order to make SMEs more competitive to drive the national industrialization program. To ensure that the industrialization program succeeds, measures need to be put in place to protect SMEs from unfair trade competitions and dumping of inferior goods in the market as well as promote the patronage of local goods to boost industrial growth and sustainability.

- **Growth of the export sector:**

  The export competitiveness of a country depends on its domestic enterprises, including SMEs. The export competitiveness of an SME depends on its ability to sustain or expand its position in international markets – directly or indirectly – by supplying quality products on time and at competitive prices. This requires flexibility to respond quickly to changes in demand and skills to successfully manage product differentiation by building up innovative capacity and effective marketing channels. SMEs represent the bulk of production in manufacturing and an even larger share in services, both in developed and developing countries. They contribute over 55% of GDP and over 65% of total employment in high-income countries (OECD 2004). The flexibility and specialization of SMEs can also contribute, in some cases, to the adaptability and diversification of national production systems. In international trade, the contribution of SMEs to direct export revenues is less obvious and varies greatly, even among OECD economies. For example, SMEs contribute a substantial share of East Asian manufactured exports (56% in

This implies that demand and supply of SME financing do not clear each other due to mismatch of issues of both sides. On supply side, Taiwan Province of China, over 40% in China and the Republic of Korea, more than 31% in India). The export capacity of local SMEs can be enhanced, among other ways, through appropriate trade and investment linkages, upstream and downstream the production and service activities of TNCs and other large firms. Such business linkages already play an increasingly significant role in various segments of local SMEs, which can thus move up the technological and management ladder and become part of global and integrated chains of production. In this way SMEs also play their role in improving the balance of payment position of the economy by facilitating exports.

- **Diversification of loan portfolio:**

  A preferential treatment for loans to SMEs is fully justified since banks can achieve diversification of their loan portfolio and such diversification effects in a bank's loan portfolio reduce the bank's risk. In addition, there is generally a low loan loss ratio on SME bank deposits / banking services offered to SMEs. SME loans are small-ticket loans and therefore focus on them is a very good risk-diversification strategy for the bank. Moreover, on a risk-adjusted basis, the yield on SME loans has also been found to be better.

Need to overcome challenges to banks in SME financing

Improving access to external sources of funding is undoubtedly the main challenge for firm finance in developing countries and that fact alone justifies the attention it receives. Availability of external financing for firms depends on the wider institutional environment and lack of availability is one of the more important business obstacles firms have to overcome. Better access to finance can help new firm entry and growth, which in turn promotes growth at the aggregate level.

In Pakistan, the SME sector is confronted with a number of demand and supply side constraints hindering smooth growth of this underprivileged sector of the economy. As a result of economic slowdown and limited financing avenues, major challenges faced by SMEs in obtaining finance have been amplified. Lack of access to formal sources of finance by SMEs is one of the major obstacles. SBP has been paying special attention to address this problem and its efforts are leading to improvements in the supply of credit to SMEs. Like other developing countries, inadequate financing of SMEs in Pakistan is a result of

disequilibrium in the SME credit market. banks shy away from lending to SMEs due to:

(i) this being a highly risky sector because of its greater sensitivity to economic fluctuations;
(ii) lack of collateral;
(iii) lack of credible data on market size;
(iv) creditors' high search cost;
(v) high processing cost, etc.

On the demand side, SME industry cannot address concerns of banks due to:

(i) smaller size;
(ii) limited management capabilities;
(iii) limited resources in maintaining business account with banking requirements, etc.

These concerns of both sides show that banks are risk averse and are reluctant to extend credit to SMEs while SMEs cannot afford to meet banking requirements. In the recent slowdown of the economy, the mismatch between demand and supply of credit market of SME may worsen further signifying the need for intervention. During the current economic downturn in the country, financial indicators depict a declining trend in SME financing. On the basis of SME potential, institutional capability and historical trend, the State Bank of Pakistan signaled in 2007 that the banking credit for the sector needed to be increased up to Rs 1000 billion in 2012 to be consistent with the projected macro-economic targets of growth and employment. However, the negative growth rate in outstanding loan amount of the sector and its falling share in overall loan portfolio over the last two years have made the target difficult to be achieved.

This situation is further complicated by a rise in NPLs following the overall rising trend in NPLs of banking industry. Though the importance of SMEs during the period of economic slowdown has increased due to their distinct characteristics of reducing income inequality and poverty reduction,the banking sector has become more cautious in extending credit to the sector. The importance of SMEs in promoting inclusive economic growth in the backdrop of economic slowdown calls for removal of the constraints in financing. Lack of collateral has been recognized as a central issue in having the challenge of constrained financing for SME industry. Lending data for SMEs depicts that the share of collateral based lending for small and medium enterprises in the country is more than 90 percent of the total loan outstanding amount

of the sector. This implies that banks are secured against the high risk of the sector through collateral and do not appear inclined towards clean lending (without collateral). This signifies that small enterprises especially start-ups are facing more problems in having access to finance as they do not have enough assets to offer as collateral.

- The availability of external finance is positively associated with the number of start-ups—an important indicator of entrepreneurship—as well as with firm dynamism and innovation.

- Finance is also needed if existing firms are to be able to exploit growth and investment opportunities and to achieve a larger equilibrium size.

- Firms can safely acquire a more efficient productive asset portfolio where the infrastructure of finance is in place.

Better access to finance can promote new firm entry and growth .The effectiveness of finance has a significant impact on the ownership structure, the dynamism and the resilience of the economy at large. Finance does not just raise aggregate firm performance uniformly but also transforms the structure of the economy by affecting different types of firms in different ways. The removal of financial barriers appears to be especially beneficial for small firms—which embody much of an economy's latent dynamism. Removal or reduction of financial barriers can thus broaden the sectoral range of the economy and reduce its vulnerability to sector specific shocks. The institutional environment can also influence patterns of ownership—for example, well-functioning financial and legal systems can lead more firms to incorporate and result in more diffuse patterns of firm ownership.

Access to and use of finance and the institutional underpinnings that are associated with better financial access, favorably affect firm performance along a number of different channels. If entry, growth, innovation, equilibrium size and risk reduction are all facilitated by access to and use of finance, it is most certain that aggregate economic performance will also be improved by having stronger finnancial systems.
Indeed, this result is likely a glimpse of the main underlying mechanism behind the now relatively long-established finding that a significant fraction of the differences across countries in economic growth in the latter half of the 20th century can be

explained by variations in their level of financial development. The finance and growth literature typically measures financial development by the ratio of bank credit to the private sector to GDP, an inevitably crude measure that captures only two aspects of financial development, namely, the ability of banks to mobilize resources and the degree to which they channel these resources to the private sector.

Among the dimensions not explicitly captured by this measure are the ability and success of banks in making good credit appraisal and monitoring decisions and in maintaining operational efficiency.

Finance does not just raise aggregate firm performance uniformly; it also transforms the structure of the economy by affecting different types of firms in different ways. Some categories of firms—the small and the new, for example, encounter greater difficulty in obtaining external finance than others. However, as financial access conditions improve in an economy, those that were formerly shut out have an opportunity to expand. In this way, financial sector development has consequences for the composition and performance of the enterprise sector in terms both of size and of ownership.

Financial development aids entry of small firms much more than that of large ones, but small firms usually struggle more to get finance when the environment is weak. The size and success of sectors in which small firms have a natural advantage, or those in which firms generally rely more on external finance (including export-oriented firms),are also particularly dependent on financial sector development.

Not only do small firms report higher financing obstacles than do large firms ; they are also more severely affected when they encounter these obstacles. This difference between small and large firms is even bigger for some of the specific financing obstacles reported in the World Business Environment Survey, such as collateral requirements, bank paperwork, interest rate payments, the need for special connections and banks' lack of lending resources. In addition, the lack of access to specific forms of financing such as export, leasing, and long-term finance is significantly more constraining for small firms.

To the extent that small firms embody much of an economy's latent dynamism, a weaker financial system, by constraining such firms, may condemn a country to a much slower growth path. More

generally, the economy as a whole may lose out on the potential for wealth creation in sectors that might give the economy a comparative advantage, had it not been for the sector's difficulty in accessing needed financial services. With a narrower range of healthy sectors, the economy's resilience to sector-specific shocks is also likely to be weakened. Financial development and easier access to external finance also allows incorporated, self-standing and independent SMEs to flourish. This has a range of broader implications for the identity and concentration of ownership in the economy at large.

Summarizing, access to credit supports firm growth and ultimately national growth through a variety of different channels. Providing access to credit to the most efficient and innovative enterprises has been found to be the key drivers behind the well-documented relationship between financial depth and national growth.

Need for marketing of SME banking products

Academic studies have shown that marketing plays a significant role in SMEs. On the one hand it is one of the biggest problems owner-managers face in their business operations and on the other hand, it is recognised as one of the most important business activities and essential to thesurvival and growth of the enterprises.

Unfortunately, it is observed even today, SMEs have the tendency to ignore allocating funds for marketing their business. The general attitude is to invest in tangibles like plant, machinery, additional space, etc., but not in marketing, business promotion, etc. because SMEs take it as an expense. Goodwill, which SMEs understand well, is what branding is today. The loyalty of buyers cannot be taken for granted, they must understand that only systematic marketing can assure success. That's why it is said, Business is Marketing.

However, recent surveys show that only 32.8% of SMEs spend on marketing, with the remaining focusing on building an over-sized sales force instead. So why do most SMEs not spend on marketing? Is it the quick results which sales provide that they prefer or is the investment in marketing seen as not being able to generate quality campaigns with lower budget?

SMEs pick sales over marketing

Most SMEs go for sales over marketing as that provides them with immediate results and enables them to survive the next day. However a huge percentage of SMEs also realize that once they

reach a stage of growth or expansion it's not the sales but marketing which makes the difference. Despite that fact very few actually go ahead and invest in marketing because of the assumed large investments involved.

High cost of marketing

Employing resources and further investing in external events to participate is considered the biggest expense for most SMEs and one of the reasons why they refrain from marketing. Marketing consultants and freelancers are probably the best way forward for SMEs to bring in good talent while keeping their pocket spend controlled.

Online marketing

With growing dependence on online marketing, 54% of SMEs have gone online to spread their businesses. This is another way that has helped SMEs to reach out to audiences across boundaries but because of the lack of understanding, professional development and expertise in online marketing, not many SMEs have been able to generate the kind of results that can be extracted. Having said that, online marketing provides the best way of building a brand cost-effectively and efforts to build knowledge and understanding can yield good results.

Marketing campaigns

The other big challenge is the execution of marketing campaigns - design and implementation. Traditional models of design agencies, with retainer fee, have made SMEs stay away from agencies and go to freelancers. Though freelancers have been able to help SMEs across the globe, freelancers have their own limitations. After all, a print designer can't go ahead and support an SME for digital strategy and vice versa.

Most SMEs understand the importance of marketing and how it can add more value. Yet, various researches have shown that, compared with larger firms, SMEs tend to be more reluctant to adopt a marketing approach mainly because of a lack of resources and skills. In particular, since SMEs usually lack marketing specialists and their owners/managers (i.e., the SME entrepreneurs) are usually the sole decision makers, the choice to adopt a marketing approach relies on what they think marketing is and their expectancies about the consequences of the adoption of such an approach in their organizations. This means that its use is evaluated subjectively, according to the entrepreneurs' perceptions, contexts, and mental schemes about marketing. This is in line with the recent research in this field which has stressed

the importance of the inherent characteristics of SMEs entrepreneurs in the choice to adopt such an approach.

On the one hand, more conservative and less innovative entrepreneurs are likely to reject the adoption of the marketing approach in their organizations, since it would represent an innovation in itself and, as such, may be perceived as too risky . On the other hand, also due to the peculiar characteristics of small firms (such as organizational flexibility, specialization, but also the lack of resources, marketing knowledge and skills), SME entrepreneurs who choose to adopt the marketing approach are likely to implement something that is substantially different from the marketing in larger firms. In fact, whilst marketing decision-making processes in the latter kind of organizations tend to be formal and highly structured, in small firms, such processes tend to be simple, informal, instinctive, and thus, also different from the theoretical paradigms developed in the managerial literature.

Why is marketing for SMEs important?

1. **It helps boost sales:** Marketing's primary function in most small businesses is to generate more sales. Commonly, this could be through either selling more to current customers or increasing the number of customers. How marketing does this is by creating variables in one or more of the 4Ps (ie. product, price, place or promotion).In the end, no marketing activity should be undertaken unless one is sure it will generate a decent return for his time, money and effort.

2. **It helps the entrepreneur identify and focus on new opportunities:** In cases where budgets are low, sales are stagnant or where the entrepreneur has too many ideas that he doesn't know where to begin, the marketing planning process helps him to focus his time and resources on where it will count. This could include developing new product or service offerings, targeting new potential customers or even entering new markets altogether to achieve the firm's overall business objectives.

3. **It helps to maintain or improve market share:** Marketing is a fantastic weapon for nurturing existing customers to ensure their loyalty or to survive in a competitive environment. Success here will depend on people's perception of the business, the firm's ability to develope meaningful relationships with them and value addition provided to them.

4. **Marketing can steady out revenue flows:** This is particularly a big issue in many small businesses (for example florists, gift shops, etc) who experience seasonal peaks and troughs in their sales. One of the many functions of marketing is to create a more even revenue flow but forward planning is of the essence.

What SME entrepreneurs should do:

1. **Understand their markets:** This is all about research and information collection so that the entrepreneurs get a clear picture of who their current customers are (ie. demographics, personal interests, buying behaviour, etc), what will influence their likelihood to buy and who else could be buying from them. Great places to start are customer feedback surveys, talking to sales staff and the internet.

2. **Develop marketing strategies that will help achieve business objectives:** There is no point in spending time, effort and resources on a marketing idea that sounds exciting if it doesn't contribute toward the firm's end goals. By spending time to create the right strategies, the entrepreneur will avoid unnecessary risks, wastage of resources and ensure that the purpose of his marketing strategy is achieved by means of attracting the target market.

3. **Create a realistic marketing plan:** To do this, the entrepreneur will need to generate ideas that fit with his strategies and business objectives. Marketing activities should increase in the lead up to quieter sales periods and must take into account current available resources (not just budgets). The entrepreneur also needs to understand that a marketing plan is a dynamic document, so it should be regularly reviewed especially as conditions change in the operating environment.
   Hence, whether times are good or bad, marketing needs to be recognised as a fundamental operation for any small business, not just to fix problems "now" but to also ensure future success in business.

Strategies and Marketing tools to attract SMEs

Small and medium enterprises (SME's) are the backbone for all economies and are a key source of economic growth, dynamism and flexibility in advanced industrial economies as well as for the emerging and developing economies. Financing has become necessary for them to help start up and expand their operations

and to develop new products. Therefore financing these SME's are vital. In the current global economic crisis, the issue of financing for SMEs is a pressing issue for all nations. It needs to be addressed with joint efforts by governments, financial institutions and enterprises, to enhance innovation in financial systems, products and services, and to improve the sustainable development of SMEs.

Banks and financial institutions are focusing on building a business model that focuses on growth and opportunities to develop new income streams through new operational and profitability model. There has been a greater focus for banks to promote a stable, diverse, well-functioning financial system, which is capable of effectively servicing SME's needs and working on the micro level initiatives that directly impact SMEs access to credit.

Many banks fail, however, to cater to the specific needs of this all-important segment. While true that most do have some sort of offering for SMEs, the generic nature of the offerings makes it clear that it is almost as an afterthought. The customization in some cases seems to be just the changing of the product or services name to pretend it's for SMEs, rather than changing the content and value proposition to truly benefit the end-users.

SMEs have been traditionally viewed by companies as too few as a group to be deemed as important as the personal banking segment and too low in value individually to be treated like those in the commercial banking segment. The fact that one day some SMEs will become commercial banking clients, and the fact that the employees of SMEs may / can become personal banking clients demands banks introduce / revisit their SME offerings.

Product Customization for SME customers

Winning over SMEs requires banks to customize what they do in their marketing activities, in their distribution channels and in their customer care efforts. Some financial institutions excel in how they address the needs of the SME segment. Following are some examples of what best-in-class banks are doing for SMEs:

HSBC Bank, UK: The bank has particularly excelled at providing support services for its existing and potential SME clients. These come in the form of a business networking center, where its existing clients can network with other business clients, a business start-up center, providing a wealth of resources for those looking to launch a small business, Business TV, providing various clips

around helping small businesses invest their assets, and the Knowledge Centre, providing news and know-how for SMEs – designed around planning, launching, running, growing, and exiting an SME (wisely built right around an SME's lifecycle). HSBC also has customized its portfolio of offerings around SME micro-segments, with such products as "Restaurants Insurance," "Working From Home Insurance," and "Surgeries Insurance" available to its SME consumers.

Natwest, UK: Natwest offers a practical self-assessment tool, free of charge, available to all SMEs on their website. Called the "Online Business Review," this tool allows businesses to assess themselves around six topics – Cash Flow, Customers, Finances, Management / Leadership, Managing Risk and Suppliers. Based on the responses, a detailed report is prepared for the SME, with advice on how to improve their operations; the bank naturally links problem areas and issues back to their own set of products and services, offering a solution to the problem it has itself defined for the SME.

ICICI Bank, India: The bank has segmented its SME consumers and the way in which they are serviced, based on the product and average balance a given SME holds at ICICI. Depending on the product / average balance, an SME is entered into a different tier of the Club Elite relationship management program. Entry-level Club Elite SMEs receive such benefits as priority access via the call center and invitations to exclusive events, whereas high-value SMEs in the Club Elite "Royal" tier receive prioritized service in the branches, a dedicated relationship manager (in addition to having almost all banking fees waived on various transactions).

Barclays Bank, UK: The bank is truly committed and focused on building an in-depth relationship with its SME clients and accordingly, gives back a great deal to them in ways aimed at gaining their trust. The following are just some of the free services offered by the bank to its SME clients:

- Free marketing advice via consultation with a marketing professional
- Free legal advice via a 30 minute appointment with a solicitor
- Free accounting advice via consultation with an accountant when an account is opened at the bank
- Free online business data backup (2 GB of free backup storage for documents)

- Free business skills training via a partner e-learning company called MindLeaders

Fifth Third Bank, USA: The regional US bank has a very strong credit card offering in place to entice SMEs to join their ranks. Not only is the program designed exclusively for them (unlike programs other banks offer that are the same as those offered to the personal banking segment) but also allows personal banking account points to be pooled with those earned through the program, thus allowing for a more rapid redemption cycle and further hooking SMEs. Two specific features make the program more enticing for SMEs:

- How points are earned – At an accelerated rate for business-related purchases (office supplies, airline tickets, utility payments, etc.)

- How points can be burned – Redeemed on items that can directly impact the bottom-line of the business (hotel stays, airfare, car rentals, office supplies, etc.)

Banks need to review their current strategies for winning over SMEs and ensure they are in the most effective manner addressing them appropriately via their marketing, sales, and customer care tactics. Following are a couple of tips and points that banks should consider and watch out for as they do so:

1. Sub-segments and their needs

The needs of each SME sub-segment differ , in that the nature of their business requires that each be addressed with a different set of banking products and services, complemented by a customer care strategy that is designed around their behaviors. White-collar, executive laden SMEs, for example, need be addressed with employee insurance and investment vehicles, managed through a dedicated account manager, backed up with a strong mobile and internet banking offering, whereas blue collar dominated SMEs need be addressed with free employee checking accounts, managed through a 24/7 call center, with branches conveniently located near industrial areas, offering extended hours around paydays.
While white collar vs. blue collar is one way to look at segmenting SMEs, a sector approach is also required. Retail, healthcare, manufacturing and restaurants are but a few of the most commonly addressed sectors by banks in differentiated manners, whereby various product / service offerings and

bundles are prepared to meet SME needs. Much as in the way HSBC Bank UK offers insurance products that cater to the needs of each sector, similarly key products and services must be customized.

Prior to conducting such a customization effort, it is critical for banks to truly understand their customer base, both quantitatively (conducting SME segmentation) and qualitatively (through surveys or focus groups with SMEs). This will then allow the bank to customize its offerings based on SME sub-segment value, behavior and needs.

2. Start-ups and partnerships

A significant proportion of SMEs are those deemed micro-sized, with less than 9 employees in the enterprises. Every year, thousands of new companies are opened and join the ranks of the micro enterprise segment, each requiring a significant amount of assistance in getting their businesses up and running.

Banking products and services are a necessity for most, if not all, of these businesses, in the form of checking accounts, credit cards, loans, etc. Banks seeking to make inroads with this segment of consumers can look to increase their attractiveness through offering one-stop shopping for start-ups, via the establishment of partnerships with relevant companies. Relevance here is around the needs of start-ups when they are being established; as such, partnerships should be sought with telecoms, office supply retailers, real estate agencies, employment agencies, etc., any type of company that a start-up could benefit from during its infancy. Partnerships can be formed in the sense of developing bundles and packages that provide benefits and discounts for end-users, or could be in the form of using each other's distribution channels for sales purposes.

In many markets, such partnerships don't exist, or are being tested and in preliminary stages. Banks that act quickly can gain a first-mover advantage by securing exclusive partnerships with companies that hold significant market share in their countries, and become THE go-to bank for start-up businesses.

3. Tap in to the employee base

SMEs hold potential way beyond that of what they themselves can offer a bank in terms of revenues – significant

untapped potential lies in the employees of the SMEs. Each of the employees represents a potential personal banking client for the bank; accordingly, the personal banking and enterprise departments of banks must come together to devise a strategy for acquiring them.A few methods for acquiring employees of client SMEs include:

- Creating an incentive for the SME to drive consolidation of employee accounts at the bank (i.e. waiving all banking fees if accounts are brought under the bank's operations).

- Creating an incentive for the employees to switch their accounts to the bank (i.e. giving double bonus points via the bank's loyalty program to personal banking clients who receive a direct deposit monthly from another account at the bank)

- Providing group benefits for SMEs that hold a certain amount of pooled accounts with the bank (i.e. SMEs that have a total of 10 or more enterprise or personal banking accounts with the bank receive a voucher each month for a team dinner).

Any of the above scenarios or others each need to be tested for their feasibility via the development of a business case; such methods could be used in a discriminatory manner, only applied to those SMEs and employees that hold a certain amount of potential for the bank. Any strategy for winning over SMEs requires a comprehensive offering be developed that meets their needs around products, services, and support, an offer set that is competitive in the market, and that is not easily duplicable.

Part Seven

Strategies to promote SME financing and SME development

Student Learning Outcomes

By the end of this chapter you should be able to:

- **Describe the role that the banks play in providing support to SME development in Pakistan**
- **Discuss the role of SBP in developing the SME sector of Pakistan via schemes and other initiatives**
- **Discuss the role of SMEDA (Small & Medium Enterprises Development Authority) in overall development of the SME sector in Pakistan**
- **Discuss the role of PSIC (Provincial Small Industries Corporation) in overall development of the SME sector in Pakistan**
- **Discuss the role of IFC/World Bank, ADB, DFID and other agencies in overall development of SME sector in Pakistan**
- **Discuss the role of TDAP (Trade Development Authority of Pakistan) in overall development of SMEs in Pakistan**

We are well aware that Small and medium-sized enterprises (SMEs) play a crucial role in the social and economic development of Pakistan, where they produce a wide range of goods, provide employment for a large number of skilled and semi-skilled workers in both urban and rural areas, account for a substantial proportion of manufacturing output, and make a major contribution to the country's balance of payments.They also play a prominent role as existing or potential producers of export goods.SMEs may thus be justifiably characterized as the principal building blocks of the Pakistani economy, providing the country with many opportunities for increased employment (including female employment) and poverty eradication on the one hand, and enhanced productivity, competitiveness and international market penetration on the other.

Despite its importance as an engine of growth in the Pakistani economy, the SME sector continues to suffer from a variety of weaknesses.These lingering weaknesses have been widely recognized by the government and other developmental partners in Pakistan, who have attempted to overcome them through a number of measures introduced in recent years.To address the policy-level constraints, the Government of Pakistan introduced a new economic policy on 15 December 1999, which places high priority of the promotion of SMEs.

Several major ministries have the primary public responsibility for regulation and promotion of the SME sector, especially the Ministry of Industries, the Ministry of Commerce, and Ministry of Science and Technology.However, as they address a broad constituency, the bodies that are most directly responsible for SME development and promotion are:

- **The State Bank of Pakistan (SBP):**

  which regulates credit, including that to SMEs.

- **CommercialBanks:**

  either private or public engaged in offering products and services of financing to SMEs.

- **Specialized Banks:**

  like SME Bank which provides finances only for the SME sector.

- **Small and Medium Enterprises Development Authority (SMEDA):**

  established under the federal Ministry of Industries to promote and facilitate SME development.

- **Provincial Small Industries Corporations (PSIC):**

  which work to promote, develop and support small, cottage industries in respective provinces.

- **Pakistan Banks Association (PBA):**

  coordinates effort of the banking industry and focuses on issues related to the development of the banking sector.

- **Business Support Fund:**

  a nonprofit organization created to assist both the SMEs and the Business development services providers (BDSP's).

- **Trade and Development Authority of Pakistan (TDAP):**

  The Export Promotion Bureau (EPB) –now TDAP, which is associated with the Ministry of Commerce and acts as a facilitator to help SMEs gain access to foreign markets.

- **International Organizations:**

  Such as the World Bank/IFC, Asian Development Bank, Department for International Development, all working to promote SME sector development in Pakistan.

The State Bank of Pakistan (SBP)

State Bank of Pakistan is the primary regulatory agency for monetary policy in Pakistan. As such, promotion and regulation of formal sector finances to SME is under its domain. SBP, on September 15, 2007, established an SME department which aims to develop and promote an enabling regulatory framework, accompanied by effective measures to focus on capacity development of financial institutions, spreading awareness about SME finance, and contribute effectively towards promotion of SMEs. It also aims to create an integrated inclusive financial system corroborated by effective regulatory measures to bring SMEs and export-led industrial sectors into mainstream macroeconomic framework, on a fast track basis, with ready access to both formal and incentivized sources of finance.

In July, 2008, as a result of the re-organization, the Refinance Division of Microfinance Department was merged into SME Department and renamed as SME Finance Department. The SME Finance Department now consists of the following three Divisions:

1. Strategy & Policy Division
2. Special Initiatives Division
3. Refinance Division

Brief functions and objectives of these divisions are as given below:

Strategy and Policy Division

This division is responsible for the following:

- Suggesting improvements in SME finance strategy and measures for its implementation;
- Coordinating meetings of SME Core Group/sub-committees to discuss issues related to SME finance;
- Reviewing of the existing Prudential Regulations in light of the specific requirements of the clusters in special and SME sector in general as well as capacity building of Banks/SMEs.
- Furthermore, the division also prepares quarterly reviews of SME finance that enables SBP to analyze the overall financing trends in the SME Sector.

Special Initiatives Division

This division undertakes special initiatives for enhancing finance to SMEs. In this perspective, concept papers are being prepared for introduction of Credit Guarantee Schemes, Venture Capital Funds, Credit Scoring Mechanisms and Credit Rating Agency, etc.

Refinance Division

This division is responsible for formulating and implementing short and long-term credit schemes for promoting exports of the country and oversee the flow of banks' credit for commodity operations.

Some of important steps taken by SBP for the promotion of SME finance are:

- SBP developed a strategic financial roadmap document for SME finance in Pakistan for next five years, known as SME Finance Strategy of SBP. Primarily this strategy deliberates upon the various issues which hinder the growth of finances in this sector.
- The establishment of an SME Help Desk at the SBP to provide an enabling regulatory and policy framework to facilitate the extension of finance to SMEs. The SME Help Desk provides valuable assistance / guidance / information to the stakeholders such as SMEs, Banks, DFIs, SMEDA,

Chambers of Commerce and Industries, other public and private sector organizations on issues falling in the domain of the SBP.

- SME ratings could play a pivotal role in boosting SME Finance through provision of better understating of risks associated with the sector.SBP adopted a two Pronged Strategy for Promotion of SME Ratings in Pakistan. On one hand, it is constantly encouraging the existing credit rating agencies to venture into SME rating business, while on the other side SBP has developed a "Concept Paper on SME Credit Rating Agency "for Pakistan.

- SBP is also promoting the idea to establish a private equity fund in Pakistan for SMEs. SBP has prepared an initial concept paper, keeping in view the peculiar dynamics of SME sector, which presents a conceptual framework for the establishment of the Fund exclusively meant for equity financing.

- SBP prepared a concept paper on Credit Guarantee Scheme with special reference to Pakistan. This paper reflects on the experiences of different countries across the world and provides a brief of recommendations regarding the establishment of credit guarantee mechanism in Pakistan. In order to go ahead with its implementation SBP has already taken feedback from Pakistan Banker's Association (PBA) and plans to coordinate with other stakeholders that also include IFIs.

- SBP is contributing towards capacity development of banks in SME finance area to lift up prevailing SME finance portfolio and extend its outreach. The human resource skills level in banks currently involved in extension of SME finance needs further improvement, which is hindering the overall integrated efforts for broadening the coverage in this sector. In this connection, SBP chalked out a two tier capacity development program for banks in SME finance. Likewise, SBP has also been conducting seminars and workshops in SME clusters on improving the delivery channels of credit for SME finance.

- The State Bank of Pakistan (SBP) has also launched a new project on clusters survey of 10 important small & medium enterprise (SME) clusters in the country. According to SBP, the objective of this project/survey is to provide credible

information base on key SME clusters/sub-sectors of economic importance. Funded by the Department for International Development (DFID), UK , the project will develop key drivers of business of important SME sub-sectors located in various cities across the country. The clusters selected for the survey included cotton ginning, marble and marble products, plastic products, hand-made carpet manufacturing, leather products, dry-cleaning and laundry services, beauty parlors and spa, super markets and retail shops, printing press and gem & jewelry. This is an important project as availability of reliable and comprehensive data on SMEs play a critical role in the development of the sector, helping the relevant stakeholders in devising sector-specific effective business strategies. This Project would specially help banks in targeting the selected SME clusters through appropriate banking products and marketing/distribution strategies, thereby increasing their penetration in SME sector. It may be pointed out that SBP, in collaboration with International Finance Corporation (IFC) and Lahore University of Management Sciences (LUMS), has recently completed similar projects on 11 other important SME clusters.

Special Prudential Regulations for the SME sector

Keeping in view the important role of Small and Medium Enterprises (SMEs) in the economic development of Pakistan and to facilitate and encourage the flow of bank credit to this sector, a separate set of Prudential Regulations specifically for SME sector has been issued by State Bank of Pakistan. This separate set of regulations, specifically tailored for SMEs, is aimed at encouraging banks/DFIs to develop new financing techniques and innovative products which can meet the financial requirements of SMEs and provide a viable and growing lending outlet for banks/DFIs.

The main points mostly mentioned in the preface of these regulations are as under:

- Banks/DFIs should recognize that success in SME lending requires much more extensive involvement with the SMEs than the traditional lender-borrower relationship envisages. The banks/DFIs are, thus, encouraged to work in close association with SMEs. The banks/DFIs should assist and guide the SMEs to develop appropriate systems and effectively manage their resources and risks.

- The banks/DFIs are encouraged to prepare a lending program (including detailed eligibility criteria) for each specific sub-sector of SME in which they want to take exposure in a significant manner. For this purpose, the banks/DFIs may conduct/arrange surveys and research to determine the status and potential of specific SME sub-sectors.

- The banks/DFIs should prepare comprehensive guidelines/manuals and put in place suitable mechanism/structure, aided by proper MIS, to carry out the activities related to SME financing in an effective way.

- State Bank of Pakistan encourages banks/DFIs to lend to SMEs on the basis of assets conversion cycle and future cash flows. A problem, which the banks/DFIs may encounter in this respect, is the lack of adequate information. In order to overcome this problem, banks/DFIs may also like to prepare general industry cash flows and then adjust those cash flows for the specific borrowers keeping in view their conditions and other factors involved.

- Presently, most of the SMEs in Pakistan lack sophistication to have reliable and sufficient data and financial information. In order to capture this data and information, banks/DFIs will need to assist and guide their SME customers. The banks/DFIs may come up with the minimum information requirements and standardized formats for this purpose as per their own discretion.

- For better understanding and to facilitate their SME customers, banks/ DFIs are encouraged to translate their loan application formats and brochures in Urdu and other regional languages.

- Banks/DFIs should realize that delay in processing the cases might frustrate the SMEs. Banks/DFIs are therefore encouraged to process the loan cases expeditiously and convey the decision to the SME borrowers as early as possible.

- In order to encourage close coordination of the officials of the banks/DFIs and SMEs, the banks/DFIs may require the concerned dealing officer to regularly visit the borrower. For this purpose, at a minimum, the dealing officer may be required to pay at least one quarterly visit and document the state of affairs of the SME.In addition, an officer senior to the

ones conducting these regular visits may also visit the SME at least once in a year. The banks may, at their own discretion, correlate the frequency of visits with their total exposure to the SME borrower.

- State Bank of Pakistan will closely monitor the situation on an ongoing basis and work proactively with banks/DFIs to make SME financing a success. During this process, SBP will keep on reviewing regulatory framework to ensure that any impediment is immediately removed while ensuring that banks/DFIs observe due prudence and necessary oversight.

- Banks / DFIs are allowed to take clean exposure on an SME up to Rs. 3 million provided that funded exposure should not exceed Rs. 2 million.

- The maximum exposure of a bank/DFI on a single SME shall not exceed Rs 75 million. The total facilities (including leased assets) availed by a single SME from the financial institutions should not exceed Rs 150 million provided that the facilities excluding leased assets shall not exceed Rs 100 million.

Commercial Banks

Commercial banks, both private and public, are playing a role in providing finance to the SME sector. Currently over a dozen commercial banks are engaged in SME financing in Pakistan, offering various products. For example, the National Bank of Pakistan (NBP), Pakistan's largest state owned bank, offers following three types of products and services to the SME sector.

- **NBP Karobar:** offers schemes like Mera Apna Karobar

- **President's Rozgar Scheme:** for people aged between 18 and 45 years, easy financing for self employment offered as NBP Karobar Utility Store, NBP Karobar Mobile Utility Store, NBP Karobar Mobile General Store, NBP Karobar Transport, NBP Karobar PCO, NBP Karobar Tele-Centre.

- **NBP Kisan Dost:** offers finance facility up to Rs. 500,000/- for landless farmers against personal guarantee.

All the above schemes are subjected to the availability of subsidies from the government. This means that its outreach is limited and is uncertain.

Another example of a public sector bank providing services to the

SME sector is Bank of Khyber (BOK). Owned by the NWFP government, BOK is offering micro finance facilities through almost all of its NWFP based branches that aims at poverty alleviation by creation of income and employment generation activities. It launched micro business development in 1995 and rural financial services in 1997. This was the first formal and structured initiative by a commercial bank to broaden the base for micro enterprise market. The initiative was further strengthened and encouraged by various multilateral institutions such as Asian Development Bank (ADB), International Fund for Agricultural Development (IFAD), KFW (German Development Bank) and Swiss Agency for Development Cooperation (SDC) through credit lines and technical assistance. BOK provides micro enterprise and group loans for existing and new enterprises engaged in value addition process, requiring technology improvement or working capital. It provides Micro-enterprise Loans to a maximum of Rs. 100,000. However fresh loans are considered for below Rs. 50,000 and Group Loans to members of organized rural communities and urban clusters to a maximum of Rs. 30,000 per member.

An example of a private bank's role in SME sector is Askari Bank. Under the Business finance scheme Askari Bank is providing loans to SMEs. The Scheme's stated goal is to offer a loan, which enables business community to receive the financing required by them based on their cash flows. It claims to provide financing on attractive terms with the minimum processing turnaround time. It provides finances up to 60% of the assessed market value of residential/commercial property, through equitable/token mortgage.

Allied Bank and First Women Bank Limited have also started schemes to provide loans to low income clients who are generally not able to access formal source of financing. Recently, HBL and Bank Alfalah have undertaken projects to facilitate and promote the SME sector.

SME Bank

The SME Bank was formed and incorporated as a public limited company under the Companies Ordinance 1984. The Government of Pakistan is the major shareholder of the bank. As part of financial sector restructuring program of Government of Pakistan, Regional Development Finance Corporation (RDFC) and Small Business Finance Corporation (SBFC) were amalgamated into SME Bank Ltd effective January 1, 2002.

SME Bank was established to address the financing and business

support requirements of SMEs. It is Pakistan's premiere SME lending institution with its network in SME concentrated areas e.g. Sialkot, Gujranwala, Multan, Sukkur, Hyderabad, Mirpur, D.I.Khan, Gilgit, etc. Providing financial assistance and business support services to small and medium entrepreneurs form its core activities.

The SME bank is Pakistan's premiere SME lending institution with its network in SME concentrated areas e.g. Sialkot, Gujranwala, Multan, Sukkur, Hyderabad, Mirpur, D.I.Khan, Gilgit, etc. It aims to support and develop the SME sector by providing necessary financial and technical assistance on a sustainable basis. It exclusively caters to the needs of the SME sector, and was created to address the needs of this niche market with specialized financial products and services. The stated objectives of the SME Bank are as follows:

- To support, develop and promote SMEs by providing them the necessary technical and financial assistance.
- To concentrate on value addition and export-oriented SMEs
- To enable SMEs to play a vital role in stimulating GDP growth, create job opportunities and reduce poverty.

To achieve these objectives SME Bank offers following products:

Lending Products: In this category, SME Bank offers:

1. Smart Loan facility,
2. Asset finance,
3. Running finance and
4. Leasing through its subsidiary to the Small and Medium Enterprises.

Banking Products: SME Bank offers commercial bank services like saving, current and fixed deposit accounts for individuals, proprietorship, partnership and limited companies starting from Rs 25,000. In 2008 SME bank launched SME Card, a Debit Card which gives its holder unlimited access to his/her current/saving account. It offers Smart Loan Facility for fixed and running needs of small businesses. This is designed for existing small-scale

businesses to cater for their fixed and current investment needs. It is a term loan facility approved for a period of up to three years and repaid in equal monthly installments. The existing SME Bank borrowers can also avail this facility.

Small and Medium Enterprises Development Authority (SMEDA)

SMEDA was established in 1998 under the Federal Ministry of Industries and Production to promote and facilitate SME sector in Pakistan by creating a conducive and facilitating environment as well as by providing and facilitating service delivery to SMEs for enhancing their capacities and competitiveness.

SMEDA's objectives are as follows:

1. Formulate Policy to encourage the growth of SMEs in the country and to advise the Government on fiscal and monetary issues related to SMEs.
2. Facilitation of Business Development Services to SMEs.
3. Facilitate the development and strengthening of SME representative bodies associations/chambers.
4. Set up and manage a service provider's database including machinery and supplier for SMEs.
5. Conduct sector studies and analysis for sector development strategies.
6. Facilitate SMEs in securing financing.
7. Strengthen SMEs by conducting and facilitating seminars, workshops and training programs.
8. Facilitate Donor assistance for development of SMEs through programs and projects.
9. Assist SMEs in getting international certifications (such as UL, CE, DIN, JIS, ASME, KS, etc.) for their products and processes.
10. Identification of service opportunities on the basis of supply/demand gap.

SMEDA provides following Services to promote the SME Sector in Pakistan:

1. **Training Services:** SMEDA conducts training need assessments every year by applying tools such as questionnaires and focus group meetings etc. in order to identify the existing training needs of industry and businesses, particularly SMEs.

2. **Business Development:** Business plan development services is one of the key services provided to enable existing as well as potential investors to make well researched and informed investment decisions.

3. **Financial Services:** Financial Services Group (FSG) is one of the support units of SMEDA. As the name suggests, FSG is responsible for all financial consulting and advisory services that SMEs may require. As for all the support functions, FSG caters to both internal sector teams as well as any external walk-in SMEs. In addition to such consulting services, FSG also acts as coordinator of government schemes, which involve financial institutions.

4. **Information Resource Center:** SMEDA Information Resource Center has been established to cater to the information needs of SMEs and stakeholders from both the public and private sectors.

5. **Policy and Planning:** Policy and Planning Division of SMEDA has dual focus, both internal and external. It plays a key role in devising and coordinating policies, action plans and strategies for SMEDA operations. It has a mandate to carry out research, communicate with stakeholders and advocate policies with different tiers of the government, with the ultimate objective of creating a conductive business environment for SMEs in Pakistan. Policy and planning is the hub of policy and regulatory research that provides SME specific policy input to all tiers of government, government agencies and institutions, SME associations, industrial clusters and individual entrepreneurs.

6. **Legal Services:** SMEDA Legal Services add value to the business of SMEs through facilitation in the following: (a) resolving their legal problems (b) creating awareness of legal rights (c) disseminating information on existing regulatory requirements through training courses, seminars, self help manuals and guides, (d) frequently asked questions, and (e) interacting with regulatory authorities and service providers for removing legal impediments.

7. **Intellectual property for business success:** Intellectual Properties (IPs) are intellectual assets that are intangible such as knowledge, creativity and inventiveness. Intellectual property in its essence is that information which has economic value when put into use in the marketplace. The rationale of protection also rests on the premise that both forms of assets (tangible & intangible) have potential of wealth creation. IPs generally falls into two categories; industrial property and copyrights. The rights of inventions, industrial designs, trademarks, integrated circuits and geographical indication are protected under industrial property while the copyrights include literary work such as novels, poems, plays, films and also artistic works etc. SMEDA assist innovative SMEs in acquiring intellectual property rights.

SMEDA has made some progress on many of the above activities. A number of pre-feasibility studies have been provided on SMEDA website, which is a good source for converting the initial commercial / business ideas into a sorted layout of figures so as to obtain facilitate the decision to start any business project, particularly in comparison with other available and viable options.

SMEDA also builds and operates industry processing utilities through and on representation from business associations to facilitate particular SMEs. These processing utilities are built in collaboration with the association(s) after establishing the genuineness of the requirement. Also, SME entrepreneurs or their nominees are invited using the database of SMEDA, for specific training programs, peculiar to any industry, on the basis of solicited requests. These training workshops add a value to the operations of SMEs.

However, a number of impediments continue to restrain SMEDA. As indicated above, SMEDA has been placed under the Ministry of Industries and Production, Government of Pakistan. It accordingly works like a centralized federal authority. On the contrary, the SMEs, by definition are local in character. The dynamics of such enterprises vary by business to business and by region to region. That is why SMEDA has so far failed to fully achieve the desired objectives and the potential the SMEs of Pakistan offer has not been fully capitalized. The policy which is devised at the head office in Lahore cannot be a true solution to the needs / requirements of the SMEs in a particular region or sector. The lack of coordination presently between SMEDA and banks has retarded the development of financing to SMEs.

The access of SMEs to the facilities, services and information provided by SMEDA has so far also been very limited. According to some sources, SMEDA has a database of 1.3 million SMEs across Pakistan but the actual number of SMEs operating in Pakistan is around 3 million. This is an indicator of the limited coverage of the SME sector. Access of SMEs (particularly by SMEs in remote areas) to the training programs in the required skills normally held at major cities, is a reflection of the limited internet connectivity in the country. Furthermore, the training material is not uploaded on the website. This shows lack of penetration of SMEDA up to the grass roots level, where the SMEs actually exist and do their business.

Lack of coordination of SMEDA with lending institutions in the form of risk evaluation / credit rating, business sector assessment, etc., despite availability of required tools and expertise with SMEDA, is another important factor hindering access of SMEs to finance. In the absence of such information, the banks persist with their requirement of collateral for lending to SMEs. Infact, absence of a coherent policy framework regarding SMEs that determines the role of all relevant stakeholders is an issue which needs attention. Issues to be addressed for SME development fall within the purview of a large number of Ministries and Departments at the federal, provincial and local government levels. SMEDA has no institutional jurisdiction or linkage with such institutions to effectively address them. Clearly, the time has come to review the structure and role of SMEDA.

Provincial Governments

Provincial governments are also playing a role in the development and promotion of SMEs. Each province has its Small Industries Corporation. Punjab Small Industries Corporation (PSIC) was established in July 1972 under PSIC Act. Since its inception PSIC is actively engaged in the promotion, development and support of small, cottage and household industries in Punjab. The stated mission of the corporation is "to promote sustained industrial development through provision of market driven credit, infrastructure and technological support and to contribute to employment generation, poverty alleviation and socio-economic uplift of the province". The objectives of PSIC are as follow:

- Investment promotion through assistance for setting up of new industries and balancing, modernization and expansion of the existing industries.

- Development of Small Sector Industries by developing small industrial estates.

- Technology up-gradation through common facility centers in industrial clusters

- Handicrafts Development through design support, credit assistance, marketing outlets and craft development centers

- Poverty alleviation by creating new jobs in private sector

- Contribute towards improvement in the environment by providing financial assistance for purchase of 4-stroke CNG rickshaws and conversion of diesel buses into CNG.

PSIC has already successfully implemented Self Employment/Rural Industrialization Credit Program. PSIC has now earmarked Rs.1,200 million for provision of soft credit to potential entrepreneurs. The scheme has an upper limit per loan of Rs. 3.0 million, repayable in 5 years. Loan sanctioning is processed in 7 weeks under a one-window operation. The mark up rate is 8-9 per cent. In addition to this, an allocation of Rs. 500 million has been made for small and cottage industries which will promote self employment. An allocation of Rs. 10 million has also been made to provide loans of up to Rs. 40,000/- for two years for crafts development [including loans to skilled women].

Besides PSIC, there is the North-West Frontier Province Small Industries Development Board (NWFP SIDB) and the Sindh Small Industries Corporation (SSIC).

The NWFP Board was established to give loans to borrowers for the purpose of small, cottage and other industries in N.W.F.P. It also furnishes guarantees to the Schedule Banks for the repayment of loans by borrowers for the development of industries and to share losses on account of bad debts in accordance with the agreement in this regard between the Board and participating. Following are the stated objectives and functions of the board:

- Establishing, in special case and with the prior approval of the Government, small and cottage industries, in less developed areas;

- Establishing small industries estates;

- Establishing artisan colonies, design centers, workshops, institutes for promotion and development of handicrafts;

- Taking appropriate means for promotion and development of small industries;

- Procuring and distributing to cottage and small industries, raw materials, machinery and spare parts;

- Establishing institutes for the promotion and development of cottage, small and other industries;

- Maintaining and running depots for the supply of raw materials and for the purchase and sale of finished goods from cottage and small industries and projects run by the Board;

- Introducing better means of production and new designs, including prototypes;

- Formulating and implementing schemes for training of artisans and small entrepreneurs;

- Arranging for grading and standardization of products of small and cottage industries;

- Working out entitlements of raw materials of cottage small and other industries;

- Sanctioning funds for balancing and modernization. of cottage, small and other industrial units

Sind Small Industries Corporation (SSIC), Government of Sind was established under the Act XXVI of 1972, for the development and promotion of Small & Cottage Industries including Handicrafts in the Province of Sindh. Its stated mission is "to promote & develop small & cottage industries". SSIC has established 16 Small Industrial Estates and three Industrial Parks in almost all in district headquarters of Sind Province. Furthermore, assistance is being provided to working craftsmen for the marketing of their handicraft products. The stated objectives are as follows:

- To promote & develop small and cottage Industries including handicrafts.

- To establish small industrial estates/industrial parks.

- To provide basic infrastructure facilities i.e. road, drainage, water supply, sui gas & electricity.

- To motivate and encourage people of rural areas, for the setting-up of small & cottage industries.

- To impart training to the unemployed local youth in traditional & non-traditional crafts.

- To prepare new development schemes through ADP and submit to the Government.

- To provide assistance to craftsmen and women in designing and adoption in accordance with the choice of buyers.

- To provide marketing facilities to the craftsmen & women through Handicraft Shops and national as well as international fairs, festivals & exhibitions.

- To establish artisan Colonies and workshops, for the promotion and development of handicrafts.

SSIC has been successful in the establishment of small industrial estate (extension) in Hyderabad, Mithi, Ghotki, up-gradation of 13 small industrial estates in Sindh. New schemes are also included in the current provincial Annual Development Programme, including the establishment of small industrial estate for power looms at Hyderabad, small industrial estate (extension), at Larkana and Sukkur.

Trade Development Authority of Pakistan

The Trade Development Authority of Pakistan (TDAP) was established in November 2006 as a successor to the Export Promotion Bureau (EPB), with the aim of promoting Pakistani trade holistically rather than just focusing on export promotion, as its predecessor EPB had done.

In 2004, the EPB (now TDAP) decided to make available US$ 211,000 under a self-financed trust fund agreement, plus a variety of additional in-kind contributions, to finance a project for the implementation of important follow-up activities in five SME pilot clusters. This commitment was the first of its kind ever entered into by an official Pakistani entity to provide national funds to a multilateral development agency to finance its activities in Pakistan. In recognition of the unprecedented nature of this agreement, the release of the first tranche of this payment (US$ 70,000) in February 2005 was accompanied by the release of US$ 50,000 in UNIDO counterpart funds.

Within the framework of the national Trade Policy, the TDAP prepared several additional clusters for inclusion into the program, including:

- The sports goods cluster in Sialkot;
- The surgical instruments cluster in Sialkot;
- The automotive components cluster in Karachi;
- The knitwear cluster in Karachi;
- The knitwear cluster in Lahore;
- The electrical appliances cluster in Karachi; and
- The electrical appliances cluster in Lahore

Within its facilitation division, the TDAP also has one section for women entrepreneurs. This section stresses the role of innovation and quality in exports. This is made evident e.g. by organizing seminars related to best business practices for exports or how to start businesses. Since 2001, a network for women exporters, WEXNET, has been developed, and exhibitions arranged in Lahore in the years 2001, 2002, 2003, 2005, 2006 and 2010. WEXNET serves as a mega platform for women entrepreneurs from all over Pakistan to interact as well as promote and exhibit their products for exports. In the 2010 exhibition, 264 women entrepreneurs presented their products for around 60,000 visitors. The majority of these (65%) were from Punjab, close to 20% from Sindh, while the other regions were present with fewer entrepreneurs. The same section of TDAP also maintains a database of women entrepreneurs to promote accessibility and facilitate interaction.

TDAP has over the past three years ensured Pakistan's participation in 215 fairs and exhibitions across the world. In terms of subsidy offered to participating exporters, textile products got a 50 percent subsidy in the cost of stall, other core products 60 percent and developmental products were given 70 percent subsidy in total cost.

During 2008-2009, TDAP held some 73 fairs and exhibitions, 62 in 2009-2010 and 80 during the fiscal year 2010-2011.

Core categories in these fairs included textile and garments, raw cotton yarn (all types), fabrics, garments, made-ups (excluding towels), towels, art silk and synthetic textiles. Other core categories were rice, leather and leather products, sports goods, carpets and wools, surgical instruments, petroleum products.

Developmental products included fisheries, poultry, fruits, vegetable and wheat, IT software and services, marble and granite, germs and jewelry, engineering goods, chemicals, healthcare and general.

For new female/male exporters and events in 'new geographic areas,' the subsidy level on stall cost was 70 percent for all three categories. Similarly, women entrepreneurs are encouraged by allowing 50 percent additional subsidy in trade fairs, exhibitions. The trade policy encourages SMEs, women entrepreneurs and new exporters by allowing special quota to them for participation in trade fairs, exhibitions. TDAP provides 50 percent subsidy on space rent and the cost of stall construction to trade bodies, ensuring their participation in product-specific events. Participation in such international fairs provides a unique opportunity to exporters to showcase their products abroad and negotiate business deals.

World Bank/ International Finance Corporation:

Over the past decade, International Finance Corporation (IFC), a part of the World Bank Group, has played a critical role in helping small and medium enterprises worldwide gain greater access to financing.IFC works to increase access of SMEs to financial services in developing countries by providing funding for equity, loans, and mezzanine finance to financial intermediaries focusing on SME financing, and by building capacity of financial intermediaries and raising awareness on best SME Banking practices. IFC uses both investments and technical assistance to support financial intermediaries outreach to the SME sector more effectively and efficiently. Investments made by IFC in financial intermediaries focusing on SME lending have included equity investments, loans, revolving credit lines, and risk mitigation facilities. On the advisory side, IFC supports enhance banks SME operations in areas such as strategy, market segmentation, product development, risk management and IT/ MIS facilities.

IFC considers Pakistan a priority country, and for the past three years, its investments and advisory services work have increased in Pakistan to promote private sector growth.

In May 2010, The State Bank of Pakistan (SBP) and IFC launched a Joint Project on Small & Medium Enterprises Market Segmentation with a view to providing credible information base on key SME clusters/sub-sectors of economic importance. The objective of the Project, funded jointly by SBP & IFC, was to develop key drivers of business of important SME subsectors located in various cities of the country.

The Project which included a study of over 300 interviews of small businesses in 10 sectors including agriculture, education and logistics specially helped banks in identifying and targeting priority SME segments through appropriate products, program schemes and marketing/distribution strategies, thereby increasing their penetration into the SME sector. At the completion of the survey, SBP in collaboration with IFC launched a series of publications which were aimed at helping the banks in creating better and low-cost product programs for financing small businesses. They covered issues like market assessment, risk assessment, financial benchmarking, proposed banking products for the sector, and guidance on how these products could be channeled and distributed. SBP and IFC also held a dissemination workshop for banks at Karachi wherein the surveying consultants shared key features and findings of the Project with the participating banks.

This was an important project as availability of reliable and comprehensive data on Small & Medium Enterprises play an important role in the development of SME sector, helping relevant stakeholders to devise sector-specific effective regulatory and policy strategies.

In March 2009, Standard Chartered Bank and International Finance Corporation launched a Partnership to support the training and growth of Small and Medium Enterprises (SME) in Pakistan. The pilot project was launched in Lahore, Gujranwala, Sialkot and Faisalabad, targeting more than 100 entrepreneurs in these cities. IFC was Standard Chartered's primary partner in delivering the program. IFC have trained and certified trainers to use their leading Business Edge material and translated it into Urdu for use in Standard Chartered's workshops.

In June 2011, IFC entered into an agreement with the Habib Bank to expand its small business lending program. The program initially targeted the Lahore region – a hub of 45 % of the country's small and medium businesses — where IFC helped HBL design and roll out financial services and banking products aimed at small businesses. These products and services will then be launched countrywide through Habib Bank's extensive branch network.

Through this project IFC is helping expand small businesses' access to finance and supporting sustainable economic growth in Pakistan. The small business sector is a driver of job creation and economic growth, and supporting it is an important part of IFC work."

IFC also supports gender opportunities and believes that financing women entrepreneurs is profitable. This has led to gender being integrated into IFC’s flagship SME Banking advisory product and a commitment that 25 % of our financial markets investments for SME lending will be targeted to women-owned businesses. In Pakistan, courts can take a long time to resolve business conflicts—typically 976 days, tying up considerable capital in the process. By helping introduce mediation onto the scene as a practical alternative, IFC helps women-owned SMEs break the logjam. Sponsored by IFC with support from the U.K., the Netherlands, and local partners, the Karachi Center for Dispute Resolution (KCDR) helps resolve commercial disputes quickly and cost-effectively. To date, KCDR mediators have successfully resolved more than 1,000 cases, releasing more than $21 million of assets that would have otherwise remained frozen in litigation.

Asian Development Bank

ADB has played a significant role in the SME sector development of Pakistan through its SME Sector Development Project which includes various technical assistance funds and trade finance programs. The SME Sector Development Project supports the implementation of policy reforms and the building of a market-based infrastructure for business development services (BDS) and financial services to SMEs and is structured in three subprojects:

1. Subproject 1 (Policy Formulation and Implementation) supports policy formulation, including SME policy and labor protection and inspection policy.

2. Subproject 2 (SME Business Support Fund) supports market development for SME BDS through SME Business Support Fund (BSF).

3. Subproject 3 (Market Development for SME Finance) supports market development for SME Finance, including regulatory policy development, credit information, and capacity building for financial institutions; and SMR Bank restructuring.

By expanding the reach of the Trade Finance Program in the Pakistan banking sector, ADB has helped to make trade finance available where necessary to small and medium-sized enterprises. The objective of ADB is to help improve SME's:

a. Competitiveness and facilitate their participation in the formal economy,

b. Access to business support services, and

c. Access to improved public and private sector support institutions through capacity building.

This has been achieved through a mix of policy reforms, institutional development measures, and knowledge services, partial credit guarantee and non-lending services to SMEs.

Department for International Development (DFID)

Department for International Development is a UK Government Department responsible for promoting development and the reduction of world poverty. DFID is helping Pakistan to:

- Transform education - by supporting four million children in school, training 90,000 teachers and providing six million textbook sets

- Support economic stability - by helping 1.5 million people (half of them women) to access microfinance and by providing vocational skills training to 125,000 people

- Build peace, stability and democracy - for example, by helping another two million people (half of them women) to vote at the next general election.

The UK has a long and close partnership with Pakistan and is committed to Pakistan for the long term. Increased aid to Pakistan will be linked to progress on reform, as the government of Pakistan takes steps to build a more dynamic economy, tackle corruption and bring stability.

In its fight against poverty, the Secretary of State for International Development recently announced during the World Bank Spring meetings, a new DFID initiative to support Small and Medium Enterprises. The Initiative will target 15 DFID priority countries - South Sudan, Malawi, Ghana, Sierra Leone, Liberia, Uganda, DRC, Tanzania, Mozambique, Kenya and Nigeria in Africa and Bangladesh, Nepal, Pakistan and India (poorest states) in Asia.
DFID will contribute £75 million to the new Global SME Finance Initiative to be used over a seven year period to help increase employment and investment opportunities for SMEs. The Initiative responds to the G20's call at the Cannes Summit in 2011 to scale up financing for SMEs.

The Global SME Finance Initiative is designed to enable the following results:

- create over one million new jobs.
- at least £5 billion of additional finance to over 200,000 SMEs across 15 DFID priority countries.
- at least a quarter of loans will be for women-headed SMEs.
- at least a quarter of all results are expected in fragile states.

DFID support takes a new risk capital approach to harness the network of banks in lending to SMEs. It will provide banks:

a. with risk sharing as well as liquidity, and funding for technical advice and technological innovations and
b. improved information about SMEs' credit-worthiness.

The Global SME Finance Initiative of the DFID will have three components:

- An investment facility - combining grant funds from donors and investments from development finance Institutions.
- Advisory services to improve the performance of partner financial institutions and to help improve financial market infrastructure.
- A G20 SME finance challenge winners - funding to support innovative technology based solutions including using psychometric models for assessing the risk profile of SME entrepreneurs.

In June 2012, DFID funded the “Financial Inclusion Programme” (FIP) to provide funding support to Bank Alfalah in undertaking the IFC SME Advisory Project that would help to create a sustainable, sound and integrated financial system, characterized with ready access to finance, diversified loan portfolio and extended outreach to SMEs in Pakistan.

What DFID has done for financial institutions in Pakistan:

- Helped facilitate 1.5 million microfinance loans, mostly to poor women;
- Helped set up the first and largest branchless banking system in Pakistan in autumn 2009. Since then 200,000 people have signed up to manage their money from their mobile phone, and ten million transactions have been facilitated;
- Provided capacity building grants to eight microfinance institutions serving over 1.5 million microfinance clients.

What DFID plans to do by 2015:

- DFID will help an additional 1.5 million poor people (60 per cent women) access microfinance loans by 2013;
- Support entrepreneurs across Pakistan by underwriting another 4,000 loans to small and medium businesses by 2013;
- Help expand branchless banking so that another three million people can access financial services from their mobile phones;
- Provide job and skills training for 125,000 people in the Punjab by 2015;
- Help 75,000 rural dairy farmers increase their income by improving the quality and quantity of meat and milk they produce by 2015;
- Nurture innovation by calling for and then funding the best new ideas to provide banking, microcredit, and other financial services to more poor people;
- Help transform microfinance from donor-dependent unregulated institutions in to financially sustainable regulated banks; and
- Work with the Government of Pakistan to develop a new Growth strategy, which will help the country improve competitiveness, promote innovation and entrepreneurship, and better exploit Pakistan's large domestic market.

Other Agencies

Other agencies working to promote the SME sector in Pakistan are as follows:

Pakistan Banks' Association: PBA is the representative body of the Pakistan Banking Industry. Established in 1953, its main objective is to coordinate the efforts of the banking industry, and to share a common vision of progress and development with its members. PBA Membership is institutionalized and is available only to the Banks operating in Pakistan. Currently there are 48 members, categorized into 6 groups .One group is on Small and Medium Enterprises but currently it is under formation. Its governing body is an Executive Committee (EC) comprising of 14 members, represented by the Chief Executives of the respective member institutions. PBA has 10 functional Sub Committees, each chaired by a member of the Executive Committee. One of the PBAs Sub-Committee is for SMEs.

Business Support Fund: SME Business Support Fund (BSF) is a company working under the Federal Ministry of Finance and funded by the Asian development Bank. It is a nonprofit

organization created to assist both the SMEs and the Business development services providers (BDSP's).

BSF assists in the improvement of the competitiveness of SMEs and to enhance the revenue-generating capacity and profitability of emerging businesses. It BSF provides matching grants to SME's to stimulate the use of business support services. It assists SME exporters to get consultancy services on cost sharing basis in areas like stall designing, designing of promotional material, website designing, export market diversification, market research, technical training, certification etc.

BSF only funds new engagements of business services such as short-term consultancies for production process improvement, product development and adaptation, packaging, quality improvement, moulds and dyes and installation of equipment, market and consumer research, marketing, designing or promotional material, stall designing for trade fairs and benchmarking. Funds are not available for capital expenditure or working capital. The target group comprises of taxpaying SMEs (employing up to 50 staff and having turnover lesser than Rs 50 million). BSF can support individual enterprises or a group of enterprises.

Overall, the government has launched some major institutional initiatives to support SME development in Pakistan over the last decade or so. But generally the perception of SMEs continues to be one of public sector neglect. Large-scale industries have access to the resources and much easier access to policy making for a as compared to SMEs. Prudential regulations and mindset of the formal banking sector are constraining access to credit for the SME sector. As PACRA does not have a rating system for SMEs (currently under its mandate), financial institutions consider lending to SMEs as a high risk option which increases the cost of lending and limits access to credit. Most of the financial institutions lack the capacity and resources for catering to the needs of the SMEs. They prefer financially sound entities – the corporate sector – as their clients. Even public sector banks like NBP follow this pattern. SME Bank lacks finances to adequately meet the requirements of the SMEs sector.

SMEDA provides a number of facilities to the SMEs but they are insufficient as SMEDA's outreach is very limited especially in the small urban centers and rural areas. Business Support Fund is a step in the right direction but BSF's outreach is also very limited and it cannot provide its services to a major chunk of SMEs.

Organizations working under the Provincial governments lack the necessary expertise and resources to give impetus to the SMEs. There is no coordination between SMEDA and provincial organizations like Punjab Small Industries Corporation, N.W.F.P Small Industries Development Board and Sind Small Industries Corporation. The multitude of the institutions involved have limited or no coordination with each and unclear and often overlapping assignment of responsibilities which impedes the success of the existing institutions to effectively achieve their major objective of SME development.

SME Strategy for 2010–2013

A new SME strategy for 2010-2013 was developed locally and approved by Group SME. The strategy is based on 3 pillars i.e. Consolidation in 2010, Marker Penetration in 2011 and Offer strategic solutions in 2012 & 2013.

The strategy has been successfully executed and is evident from the following initiatives:

Consolidation

- Alignment to the Group SME structure such as hiring of product specialists; setting up of SME Transactional Banking Unit
- Increased productivity by rationalizing headcount; from 261 employees in December 2009 to 88 in June 2012
- Staff quality enhanced through training and hiring senior staff
- Underwriting standards (UWS) revised from single product focus to structures facilities. Trade constitutes 67% of all new facilities booked
- Islamic specialist has been appointed and a complete suite of Shariah complaint SME Islamic Trade and lending products have been designed to cater to this segment of customers
- Cash Management products including Payments and Collection launched for SMEs
- Set up ME Ops and ME BCA Factory within business

Market Penetration

- In 2011 86 new ME names booked; in H1 2012 we have

booked 67 new names

- ME ENR increased from $105M to $247M since revision of UWS in September 2010 recording an increase of 135% in ME Footings

- SME Trade Centers are being setup throughout Pakistan that will provide convenience to both ME and SB customers

- In 2012 SME Pakistan is focused towards sustaining ME growth, start SB discretionary lending and trade through branches, liquidate/convert legacy SB LAP portfolio to new SB lending, increase deposit growth through branches, increase Trade and FX NFI, grow the Cash Management proposition

- Strategic solutions will be offered in 2013

IBP Superior Qualification

Chartered Banker

The Institute of Bankers Pakistan
A Company Set Up Under Section 42 of the Companies Act, 2017

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